

The University of Chicago

**EXEMPTION OF SECURITY
INTEREST FROM INCOME TAXES
IN THE UNITED STATES
AN ECONOMIC AND STATISTICAL ANALYSIS**

A DISSERTATION SUBMITTED TO THE FACULTY
OF THE SCHOOL OF BUSINESS IN CANDIDACY
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY

1946

By
LUCILE DERRICK

Reprinted from
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PREFACE

FOR one hundred and sixty-five years exemption of securities or their interest from taxation has been a debated question in the United States. The inception of the federal income tax in 1861 introduced new problems which added to the diversities of existing opinions on the subject, and the mounting tax rates of the present century have led to the propounding of even more bitterly contested theories. True, the arguments at times have become very heated and intense; at others, they have cooled almost to the vanishing-point. In spite of all the verbal battles which have been fought over the question, however, tax exemption of security interest is still a live issue. The income from approximately 30 per cent of the public marketable securities outstanding in 1944 was wholly or partially tax free.

It was in an effort to abstract from and evaluate the subjective theories that statistical measurements were employed in this study. However, the qualitative and quantitative aspects of the problem are not independent of each other; rather they are complementary. Each serves to check and aids in arriving at true interpretations of the other. Chapter iii, therefore, has been included to serve a dual purpose: (*a*) to familiarize the reader with the problems by giving him a panoramic view of their development and (*b*) to present the setting out of which the quantitative measurements presented in the next three chapters evolved and in the light of which the results were evaluated.

The evaluation has been delegated chiefly to chapter vii, in which an at-

tempt has been made to assign proper weights to the relative parts. This task was not an easy one. While the maximum good to be gained for society as a whole should be given first consideration, compromise often has to be allowed where such is necessary to insure administrative feasibility for a dynamic policy. Special group privileges should be subordinated to the common good, yet they should be permitted when they contribute to that primary goal. Alternative theories and policies often have to be evaluated without the benefit of seeing them withstand the tempering heats of experiment and experience.

The problems considered by the study are by no means simple. Conversely, they are complex and often even conflicting. The efforts which have been exerted to maintain the credit standing of our nation, to afford tax justice, to maximize the revenues, to minimize the tax burden, to reduce borrowing costs, and to appease special groups have been superimposed upon the pressures exerted by emergencies to produce results which are as entangled as they are intricate and complicated.

But it is hoped that through careful measurements and analyses some facts may be revealed by this study which will contribute at least in a small measure toward more enlightened public and private policy-making.

The writer is especially indebted to Professors Neil H. Jacoby, Theodore O. Yntema, and Willard J. Graham, all of the University of Chicago, for helpful counsel and guidance.

Sincere appreciation is also due many others who ably co-operated in the collection of the materials and so graciously gave of their time in stimulating discussions and conferences. In this group the writer wishes particularly to mention Mr. Roy Blough and Mr. Henry Murphy, of the United States Treasury; Mr. Edward Denison and Miss Gladys Greer, of the United States Department of Commerce; Mr. Irving Perlmeter, Mr. Edward White, and Miss Benedict, of the Bureau of Internal Revenue; Mr. Randolph Paul and Mrs. Virginia Manson, of Lord, Day and Lord; Mrs. Margaret Blachly, of the Legislative Reference Service of the Congressional Library; Mr. Harold Hufford and Mr. W. G. Caudill, of the Legislative Reference Department of the National Archives; Senators Warren R. Austin, Harry F. Byrd, Arthur Capper, and Walter F. George; Representatives Emanuel Celler, Harold Knutson, and Daniel A. Reed; and Mr. Colin F. Stam,

chief of staff of the Joint Committee on Internal Revenue Taxation.

The assistance given by the staff members of Moody's Investors Service, Standard and Poor's Corporation, Halsey Stuart Company, Inc., the Federal Reserve Bank of Chicago, John Nuveen and Company, the *Commercial and Financial Chronicle*, American Life Convention, Mutual Trust Life Insurance Company, Country Life Insurance Company, Department of Insurance of Illinois, C. F. Childs and Company, C. J. Devine and Company, the *Bond Buyer*, and Harris Trust and Savings Bank is also gratefully acknowledged.

The writer feels singularly grateful to Mr. J. Fred Weston and to Mr. and Mrs. John H. Smith for reading the manuscript, for the very constructive criticisms offered, and particularly for the friendly encouragement given while this study was in progress.

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SUMMARY AND CONCLUSIONS

SINCE the inception of the Civil War income taxes, federal security interest has gone through the stages of being partially taxed, fully taxed, wholly exempt, and partially taxed and wholly exempt by the central government but has been free from state and local levies.

State and municipal bond interest was subjected to full federal income taxation prior to the ratification of the Sixteenth Amendment but has been wholly exempt since that time. It has been subject to state income taxes where such have been imposed.

Agitation for the abolition of tax exemption for security income has been highest during periods of high tax rates and at times when large volumes of tax-exempt securities were outstanding. In 1923 a resolution for a constitutional amendment to tax fully all bond interest passed the House but was never reported to the Senate for action. In the thirties and early forties, the concerted efforts of the President, Treasury officials, and many economists and organized groups failed to induce Congress to act with reference to the taxation of interest from state and local securities. During this period the opinion was expressed by experts and gained prominence that the phrase "from whatever source derived" in the Sixteenth Amendment gave Congress the power to impose the tax without the necessity of a constitutional amendment. In 1941 all future issues of federal securities were made fully taxable under federal law.

The Supreme Court has not had the issue squarely before it since the Pollock case in 1894. The trend of more recent decisions of the Court on tangential issues seems to be toward drawing lines of demarcation between those functions of local governments which are taxable and those which are immune.

In the period 1919-40 investors were willing on the average to accept yields from 86 to 92 per cent as high as they might have received on fully taxable bonds in order to obtain full exemption for the interest on the securities. The levels of surtax rates accounted directly for 35 per cent of the 61 per cent of the variance in the yield differentials which was explained by the factors used. Corporate new capital flotations, amounts of state and local securities outstanding, and common-stock prices ranked next in order in explaining the other 26 per cent of the variance.

For the set of bonds studied, low-grade municipal security prices remained on the average about 13 per cent above those of the set of matched corporate bonds, except for 1930 and 1931, when the corporates brought the higher prices; tax exemption for interest on bonds which are in default is worthless and is so recognized by investors.

Federal bonds whose interest is wholly exempt form a unique class because of their scarcity, type of ownership, inactivity in trading, very high prices, and low yields.

Owing to the fiscal and economic conditions existing from 1925 through 1934,

the yields on partially exempt federal bonds fell below those on wholly exempt municipals. In the periods 1919-25 and 1934-41, investors accepted yields on wholly exempt municipals averaging 95 per cent as large as those obtaining on partially exempt federals. Surtax rate levels explained directly 35 per cent, and the ratio of the amount of municipal wholly exemptions to federal partially exemptions outstanding explained directly 26 per cent of the 88 per cent of the variance in the yield differentials which was accounted for.

For the period October, 1941, through November, 1945, partially exempt bond yields remained on the average 78 per cent as large as those of the federal fully taxable bonds. While at one time the yield level of the former was only 15 per cent below that of the latter, at another period the drop was to 33 per cent.

By 1961 all federal wholly exempt bonds will have disappeared from the market, and by 1960 at the earliest or 1965 at the latest all federal partially exempt securities will have matured. The municipals will then be the only type of security outstanding bearing full tax exception for its interest.

The price for tax-exempt securities is set by the marginal purchaser. All investors above this point stand to gain in that the exemption is of greater value to them than the price paid for it. The smaller the proportion of high-tax-bracket taxpayers who bid for tax-exempt securities, the greater the relative gain for the bidding group.

In a period of rising tax rates, the

holder of tax-exempt bonds receives additional windfall profits.

The full tax value reverts to the issuer in the form of prices paid only in case the supply of tax-exempt securities is so limited that the very high-surtax-bracket taxpayers are the successful bidders.

To the extent that tax losses due to the existence of tax-exempt securities outstanding is covered by all taxpayers, these taxpayers are subsidizing the gains to the investors.

The existence of tax-exempt bonds is a condition but not a cause of timid capital's hiding. Their existence, however, offers the most profitable refuge to that capital which is most able to take the risk.

If local units need subsidies in order to perform socially desirable functions, those subsidies should be applied directly, along with assistance to help them overcome their basic difficulties.

To insure equity for the greatest number, tax exemption for all security interest should be abolished. Variabilities among investors and the dynamics inherent in the conditions surrounding exemptions inject inequities. With the present status, progressiveness and justice in taxation tend to be nullified, and the very means used to accomplish a given purpose defeat their own ends.

The expenses involved in including in corporate bonds tax-free clauses are probably not directly recouped by the issuer, but indirectly they may serve a useful purpose in broadening the market base for the bonds.

CHAPTER I

THE PROBLEMS

THE study deals specifically with the exemption from income taxes in the United States of interest received on securities. The major portion of the study is concerned with an examination of the hypothesis that the premiums paid for exemption of security interest from income taxes—measured by the differences between the yields of tax-exempt and taxable securities of equal quality—are not constant but vary depending upon certain other factors, the most important ones of which are the level of the surtax rates and the amounts of tax-exempt securities outstanding; that the premiums paid vary directly with the level of the surtax rates and inversely with the amounts of tax-exempt securities outstanding.

However, it is impossible to analyze fully this central hypothesis or to determine the significance of the findings without the parallel consideration of many other closely related and influencing conditions.

For instance, there immediately arise the questions of when, how, and why the practices of allowing tax exemption for security income in this country originated; what the character of the changes proposed and instituted during the course of the development of the applications of income taxes to security interest was; and what the major causes which gave rise to these changes were.

Among the causes there is the question of the weighted effects of the attitudes of leaders in the legislative, judicial, and executive branches of the governments,

of the policies advocated by Treasury officials, of the recommendations made by certain professional organizations, and of the political pressures brought to bear through specifically interested groups. Just as significant, however, as the ideas advanced by these various persons and groups is the reasoning which has been voiced in support of the ideas.

There is also the question of the effects which these policies and practices had or might have on the economy. These effects naturally fall into three large categories: those that have fiscal aspects, those that can be classed as social and economic, and those that are of a legal nature.

Among the fiscal issues are the questions of the cost-revenue effects on the federal government, on the state and local governments, on self-liquidating and refunding operations, and, finally, on society as a whole.

To be considered for their social and economic consequences are such questions as whether tax exemption of security income does represent a "special privilege"; if so, how much the "special privilege" is worth to certain income classes of the population; and to what extent these classes have taken advantage of the "privilege." In the same class fall such considerations as that of whether the tax exemption of security income tends to carry the expenditures of local governments beyond socially desirable limits; the effects of the exemption policies on taxation principles, such as progressiveness, justice, equalization, and

ability to pay; and the extent to which funds which should function as venture capital hide in tax-free investments.

The two principal legal phases fall under the interpretation given to the meaning and scope of the Sixteenth Amendment and the comprehensiveness ascribed to the doctrine of intergovernmental immunity.

Then there are questions concerning the other major factors which may affect the premiums which investors will pay for tax exemption for their security income. It is important not only to attempt to segregate these factors but also to measure their relative significance

with respect to each other and in regard to the total influence exerted.

Of singular significance is the question of the alternatives to the current policies and the effects to be expected if each or a combination of these alternatives should supplement or replace the regulations now being enforced.

While each of the above questions cannot escape some consideration in a study of this nature, answers to all of them certainly cannot be expected. However, through the analyses additional information may be furnished which will eventually assist in leading to their equitable resolutions.

CHAPTER II

PLAN OF DEVELOPMENT

SCOPE AND METHOD

HISTORICAL ANALYSES

THE historical analyses extend from 1779, from the earliest account of security tax exemption in the United States, to the present time. This span of a hundred and sixty-five years was subdivided in such a manner as to make the component periods coincide with the major changes which have taken place in security tax-exemption policies or practices. The subperiods, therefore, are not of equal duration. The shortest covers four years, while the longest embraces twenty-one times that span. Consistency was maintained in so far as possible, however, in the nature of treatment of the materials. Each period deals with the various legislative actions and judicial decisions as well as opinions of national leaders and group pressures which have exerted any marked influence on the development. The facts, events, and theories at this point have merely been recorded in a historical fashion, with no attempt to judge their relative merits or evaluate their significances. This weighing of the various influences was omitted in order to deal with it after other phases of the study had been presented.

QUANTITATIVE ANALYSES

The quantitative analyses were employed in order to arrive statistically at the size of the premiums which investors have been willing to pay for tax exemption for their bond interest, to determine the factors which have affected the sizes

of these premiums, and to weigh the relative influences which each of these factors has exerted.

For this purpose annual differentials between the yields of bonds which have been matched in aspects other than taxability were found. Economic, social, and political conditions along with certain theoretical aspects were determining influences in the choice of factors studied. The relative weights to be assigned these factors were determined through correlation techniques.

The time period was limited to that extending from 1919 through 1941 in order to exclude so far as possible the effects of World Wars I and II. The inclusion of the years 1919 and 1941 was a compromise between excluding the war disturbances and increasing the number of available observations.

While every attempt has been made to eliminate biases and to keep inaccuracies to a minimum, perfection cannot be claimed for these results, owing to uncontrollable factors, among which are:

a) *Influences of extraneous factors.*—Owing to the vagaries of the markets, the inconsistencies and instabilities of the investing public, and the varying repercussions of dynamic forces on different parts of the economic structure, it seems safe to say that no two bonds are exactly alike. While every effort to hold constant other factors than those under study was made, it is recognized that other influences could not be entirely excluded. It is believed that in some instances, however, these extraneous effects tended to

cancel each other. In others, no doubt, they were cumulative and therefore exerted their full weights on the results.

b) *The uses of averages.*—It is fully recognized that the primary problem considered here is one which if it could be attacked entirely from the marginal standpoint would yield far more significant conclusions. With available data, however, such an approach is not possible. The results obtained are subject, therefore, to all the influences to which averages are susceptible.

c) *Imperfections in available data.*—While it is felt that for the most part the number of observations taken for any given bond for any given year was sufficient to neutralize most discrepancies in the data, such could not be claimed where the bonds were not traded with sufficient frequency to insure the necessary information. This latter situation was found to exist with reference to some of the municipal bonds. Sometimes it was extremely difficult to determine exactly which bonds were being quoted. Refinements on the data were made by means of information supplied by investment houses and by published sources.

d) *Errors of computation.*—While every check which could be applied to insure elimination of errors in computations was used, it is almost too much to expect a work of this magnitude to be entirely free of such mistakes. One cannot obtain approximately twenty thousand bond quotations, compute yields for about fifteen thousand of the quoted prices, then calculate averages from these yields without some discrepancies creeping in. It is believed that sufficient rechecking has been done, however, to insure that the final results are not seriously affected by the inevitable errors. Another margin of error can exist in the statistical hy-

potheses set up, where those chosen do not represent the optimum expression of the existing relationships.

QUALITATIVE ANALYSES

In drawing conclusions concerning a question of a controversial nature such as this one, it is very difficult for one to keep an unbiased attitude and to prevent being swayed by the very vigorous arguments which have been presented both for and against tax exemption for security income. The statistical measurements obtained in the study along with careful evaluation of the materials available have been relied upon to produce unprejudiced conclusions. In no sense would it be argued that these results are final. They, like all other research, are open to alteration or even to reformulation as new facts are made available.

SOURCES

While extensive information has been secured through published materials on the subject, some of the most valuable insights into the problem have been gained in personal conferences with political and economic leaders and business executives. Although numerous volumes have been published in which the old arguments have been reargued, very little fundamental research is available on the subject.

For bond prices and yields, the primary source was the publications of the *Commercial and Financial Chronicle*. These data were supplemented by the records of the National Bond Summary Corporation, the National Association of Insurance Commissioners, Moody's Investors Service, and Standard and Poor's Corporation, as well as by data from private sources.

Information on tax rates and amounts of tax-exempt securities outstanding were obtained from facts assembled by the federal government.

For alternative investment data, in-

cluding stock prices and new capital flotations, the compilations made by the Cowles Commission, Standard and Poor's Corporation, and the *Commercial and Financial Chronicle* were used.

CHAPTER III

HISTORICAL BACKGROUND AND DEVELOPMENT OF THE PROBLEMS, 1790-1945

TAX EXEMPTION FOR EARLY FOREIGN LOANS (THE PRE-CIVIL WAR ERA)

THE dubious credit standing of the United States in its infancy no doubt prompted officials of the foreign countries granting loans to this country to insist upon American tax exemption for the securities issued. But, in addition, Secretary of the Treasury Alexander Hamilton held to a firm belief that a government had no right to tax its funds.

As Hamilton expressed it, "to be able to borrow upon good terms, it is essential that the credit of a nation should be well established."¹ His method for establishing that credit included the strict keeping of all promises. To him public debt was "*a property subsisting in the faith of the Government. Its essence is promise. Its definite value depends upon the reliance that the promise will be fulfilled.*"² To him, the keeping of the promises and the taxing of public funds were irreconcilable. As he put it:

To tax the funds is manifestly either to *take*, or to *keep back*, a portion of the principal or interest *stipulated to be paid*.

To do this, on whatever pretext, is *not to do what is expressly promised*; it is not to pay that precise principal, or that precise interest, which has been engaged to be paid; it is, therefore, to violate the promise given to the lenders.³

¹ Communication of Secretary Hamilton to the House of Representatives, June 14, 1790 (*American State Papers, 1789-1802, Finance*, I [Washington: Gales & Seaton, 1832], 15).

² Report of Secretary of the Treasury to the Senate, January 20, 1795 (*ibid.*, p. 335).

³ *Ibid.*

It must be recalled that the income tax was not an issue which Hamilton had to consider. Even so, apparently, there were those who did not agree with his reasoning, as is evidenced by his explanation that the "proposition would have been deemed superfluous, had there never been discussion asserting a right to [tax] . . . and even the expediency of exercising that right. [The taxing of public funds] he [the Secretary] believes not only unwarranted by principle or usage, but subversive of the sound maxims of public credit."⁴

To what extent tax exemption might have been specified in our earliest loans cannot be stated. So many of the contracts covering the earliest national loans of the Continental Congress and of the United States are buried as state secrets that the terms of these contracts are not known. In order to avoid open hostilities with our then foe, England, lending countries either made no complete written accounts, or such as were made have been destroyed or completely buried. Perhaps of necessity, but much to our later detriment, our own records of this period are far from complete.⁵

⁴ *Ibid.*, p. 334.

⁵ We do know that on January 1, 1790, our total foreign debt amounted to some \$12,000,000, of which over 60 per cent was owing to France, over 35 per cent to Holland, and the balance to Spain. Our estimated domestic debt, including interest and principal, was over \$40,000,000, and, in addition, Secretary Hamilton estimated state debts of about \$25,000,000. Also during our infant struggles France and Spain expressed political sympathies with financial subsidies (see Rafael A. Bayley, *National Loans of the United States from July 4, 1776 to June 30, 1880*

It is in the Antwerp loan of November 30, 1791, that the first record of tax exemption for federal securities is found. The contract called for full exemption:

He [William Short, chargé d'affaires of the United States at the Court of France] further declares in the name of his constituents, that neither the present loan of three millions of florins, Brabant exchange money, nor any part of it, shall ever be subject to any tax or duty already imposed or which may be imposed at any future period by the United States, or some of them, not even if a war or contest should break out between the United States, or some of them, on the one side, and the sovereign of these Belgian provinces on the other side, so that the repayment neither of the present capital nor of the interest can ever be interrupted or delayed under any pretext whatever.⁶

It is possible that the Holland loan of 1792 contained the exemption clause. A copy of the contract is not now to be found. However, the following instructions concerning this loan were written to Mr. Short by Secretary Hamilton on March 21, 1792: "It is my wish that as soon as it shall be proper, after the receipt of this letter, you should proceed to borrow the sum of three millions of florins, on the terms of the Antwerp loan."⁷ Of course, "on the terms of the Antwerp loan" could have had reference to interest rates and commissions and not to the tax-exempt feature.

For the next seventy years—to the time of the Civil War—the privilege of tax exemption was not explicitly attached to federal loans.

Some of the states taxed income before 1860, but these early attempts were very crude, and in no state except Virginia was the revenue appreciable.⁸ Before the Civil War, however, the general property, or ad valorem, tax was the principal type of state and local taxation under which real and personal properties were assessed at a uniform rate. State and local governments in this period sometimes excepted their own securities from property taxation with the intention of lowering their interest charges.

PRESSURES PRODUCED BY CIVIL WAR EMERGENCIES (1860-70)

In 1861 the North realized that it was at war. It also realized that its financial condition was anything but sound. Poor fiscal management during preceding years had left the nation's credit seriously shaken. After the treasury had been emptied to the states, it had been supported principally by borrowing. An unsuccessful attempt had been made to negotiate a 6 per cent loan in Europe.⁹ In 1844 Congress had decided to reduce the national debt,¹⁰ and by 1857 the reduction had been so great that it was decided to part with some of the revenues. Scarcely had this been done when the Panic of 1857 struck. Treasury notes issued in that year could not be paid when they matured and had to be renewed until June, 1860. Congress authorized a \$25,000,000 loan, of which \$10,000,000 was offered in September, 1860, at 5 per cent. This amount was taken at

[Washington: Government Printing Office, 1882], pp. 10 and 31).

⁶ *Ibid.*, p. 25. Of the \$14,000,000 authorized for this loan, \$820,000 was issued. The securities sold at 96 and paid 4½ per cent interest. The usual rate of interest on foreign loans between 1777 and 1783 was 5 per cent (see Alfred G. Beuhler, *Public Finance* [2d ed.; New York: McGraw-Hill Book Co., Inc., 1940], p. 760).

⁷ Bayley, *op. cit.*, p. 26.

⁸ The early state income taxes for the most part grew out of the Colonial faculty taxes (see Edwin R. A. Seligman, *The Income Tax* [New York: Macmillan Co., 1911], pp. 368-406).

⁹ A. S. Bolles, *Financial History of the United States*, Vol. I: *From 1789 to 1860* (New York: D. Appleton & Co., 1883), p. 576.

¹⁰ *Ibid.*, p. 580.

par or a little premium but, before payment could be made, the bidders were unable to respond. In December, 1860, an issue of \$10,000,000 of treasury notes bearing 6 per cent was authorized. The Secretary of the Treasury, however, was allowed to pay whatever interest necessary to secure funds. Almost half of the amount was afterward borrowed at 12 per cent. Only \$70,200 went as low as 6 per cent.¹¹ It was in this unsound credit situation therefore that the North found itself when Fort Sumter was fired upon. It is little wonder that any expedient which might help to market the federal bonds and to furnish funds to defray the extraordinary expenditures of war was seized upon.

When the income-tax section was added to the 1861 tariff bill, it was proposed to allow lower rates on income from federal securities. It was argued that these lower rates would enhance the sales of the bonds and also be consistent with the exceptions "made in all countries in favor of investments in government securities."

Opinions on this issue were not uniform, however. While some members of Congress felt that total exemption should be allowed to encourage maximum sales, others held the view that the income from such investments should certainly be taxed. Even Mr. Simmons, who had previously argued for the lower rates, said that if the Senate did not want that feature, he was willing to leave it out.¹² A 2½ per cent rate on interest income was accepted by the Senate but was reduced in conference with House members to 1½ per cent,¹³ thus providing a 1½ per cent differential for federal security income,

since the regular income tax rate was set at 3 per cent. This 1861 law, however, never went into effect.

By 1862 the national picture was no brighter. Congressmen rediscussed all the arguments raised in 1861 for and against security income-tax exemption, and in addition some members declared that the income from securities could not then be taxed at a higher rate than 1½ per cent without "plighting faith," since the bonds had been sold with that promise.¹⁴ With a restatement that the rate "not exceeding" 1½ per cent would be levied on income "derived from interest upon notes, bonds, or other securities of the United States," the section was accepted. Since progressive income-tax rates of 3 and 5 per cent were imposed, this meant a differential for bond interest income of 1½ to 3½ per cent.¹⁵

During this period the banks had come to the rescue of the Treasury by taking a loan at 7.3 per cent.¹⁶ However, the necessity for decisive action on the part of Congress was apparent. In introducing the loan bill authorizing the issue of the 5-20's of 1862, it was explained that "the bill before us is . . . a measure of necessity, and not of choice, to meet the most pressing demands upon the Treasury."¹⁷ Apparently the urgency of the situation, the arguments of the tax-exemption adherents, and former Supreme Court decisions¹⁸ had weight.

¹⁴ *Ibid.* (37th Cong., 2d sess.), pp. 1531-32, 2449, 2450. Senator Howe had moved to strike out the exemption proviso and make the security income taxable like other income, but his amendment was killed, 13 to 24 (*ibid.*, p. 2454).

¹⁵ 12 Stat. 474, sec. 91 (1862).

¹⁶ A. S. Bolles, *Financial History of the United States*, Vol. II: *From 1861 to 1885* (New York: D. Appleton & Co., 1886), p. 21.

¹⁷ *Congressional Globe* (37th Cong., 2d sess.), p. 523.

¹⁸ *McCulloch v. Maryland* (1819) and *Weston v. Charleston* (1829).

¹¹ *Ibid.*, pp. 599 and 600-602.

¹² *Congressional Globe* (37th Cong., 1st sess.), pp. 314 and 315.

¹³ *Ibid.*, p. 396.

With little discussion, the Senate agreed to make section 2 read: "... all stocks, bonds, and other securities of the United States held by individuals, corporations, or associations within the United States shall be exempt from taxation by or under State authority,"¹⁹ and it so passed.

During the third session of the Thirty-seventh Congress, the Senate amendment to add exemption from municipal taxation to the state exemption previously specified was accepted by both houses.²⁰ The exemption was limited, however, to "bonds and treasury notes or United States notes issued under the provisions of this act."

By 1864 it was realized that the war would be longer than had been previously expected. The "temporary" attitude gave way, and Congress set about to equalize some of its impositions where this could be done without decreasing revenue.²¹ The argument of inequality of taxation was most often advanced against allowing differential rates on federal security income when the 1864 Congress had the income-tax bill under consideration. There were many different opinions, however, as to how this end should be accomplished. Representative Allen wanted to tax at the existing 5 per cent rate but would compromise at 4 per cent. He declared that if the government credit could not be sustained in any other way, then "let it go." Representa-

tive Pike suggested federal taxing of three-fourths of the security income but felt that municipal exemption should be continued. Representative Farnworth moved to strike out the exemption proviso, and Representative Holman moved to state that "income from interest on bonds, notes and other securities of the United States shall be included in estimating income under this section." He declared that it would be better to pay 7, 8, or 9 per cent interest for money than to withdraw the securities from taxation.²² Mr. Holman's amendment was accepted by both houses and was incorporated in the income-tax law of that year.²³ Thus income from federal securities was made fully taxable by the central government, and so it remained until 1870.

The 1864 loan bill, providing that "all bonds, treasury notes and other obligations of the United States shall be exempt from taxation by or under State or municipal authority," was objected to on the grounds that it would exempt the entire floating debt of the nation, and the policy of exempting any bond income was discussed at length. It was asked on what theory the Ways and Means Committee proposed the exemption. To the

¹⁹ *Congressional Globe* (38th Cong., 1st sess.), pp. 1854 and 1875.

²⁰ 12 Stat. 346, sec. 2 (1862). One of the advertisements for these securities made no mention of tax exemption but merely referred to "this desirable loan" (see "The Course of Tax Exemption," *American Bankers' Association Journal*, XXVI [February, 1934], 35).

²¹ 12 Stat. 710, sec. 1 (1863). Senator Powell had wanted to allow the states to tax federal security income, but he was reminded by Senator Fessenden that the Senate would not permit the states to tax its stock (see *Congressional Globe* [37th Cong., 3d sess.], p. 926).

²² Bolles, *op. cit.*, II, 188.

²³ 13 Stat. 281, sec. 116 (1864). This law raised the income-tax rates to 5, 7½, and 10 per cent, but before this act went into effect, it was superseded by the Act of 1865. Also additional special income taxes were imposed in July, 1864, increasing the lowest rate to approximately 8 per cent. This special law taxed bond interest "as in existing law" (see Thomas Frost, *A Treatise on the Federal Income Tax Law* [Albany: M. Bender & Co., 1913], p. 186; and *Congressional Globe* [38th Cong., 1st sess.], pp. 3509-47). The 7½ per cent rate was dropped in 1865, and in 1867 the progressive principle was deleted and a flat 5 per cent imposed. No further change was made in the rate imposed until 1870, when it was lowered to 2½ per cent (see 13 Stat. 479, Amendment to sec. 116 [1865], 14 Stat. 477-78, sec. 13 [1867], and 16 Stat. 257, sec. 7 [1870]).

response that practice and not theory was being followed, it was retorted that practice was no criterion; the past was not like the present; local debts were formerly small but had been greatly increased through war necessities. It was even suggested that the exemption would not sell bonds, since it was no longer popular to escape local taxation, and that a privileged class was being created. It was asked whence came the power to make the exemption.²⁴ The amendment to strike out the provision for exemption, however, failed.²⁵ The strongest arguments raised against the amendment were the necessity for the sale of the bonds, that of "plighted faith" toward investors, and the exposure of the federal government to the taxing whims of the states.²⁶

During the closing days of 1864 and into 1865, new attempts were made to open federal security income to state and local taxation, but without success in the face of the belief expressed by leaders that the bonds would not sell if taxed.²⁷

Mr. Wentworth, when addressing Congress in 1866, proposed that the way to overcome the "unpopular non-taxation provision in the bonds" was to pay the debt and reduce taxation²⁸—a recommendation to avoid the problem without solving it—a recommendation which has

been echoed in the twenties of the present century. Mr. Wentworth was of the opinion that legally there was no way for the states to tax federal security income. Nevertheless, Mr. Pike introduced an amendment for that purpose,²⁹ but he was ruled out of order, and the bill passed with the previous exemptions from state and municipal taxation.³⁰

By 1868 the federal needs no longer seemed so urgent, and states' rights received increased attention. Congressmen argued that the states should not be deprived of the income through federal security exemptions. New plans were therefore introduced for circumventing the legal barriers. These plans included a proposal to have the national government impose a withholding tax at a rate sufficient to offset the escape from local taxation.³¹ The House instructed the Ways and Means Committee to report a bill embodying a federal tax of 10 per cent on the income from exempt securities—a rate double the regular income-tax levy.³² The bill was reported but with the strong statement that "they [the Ways and Means Committee members] reserve to themselves their rights . . . to oppose in every possible way the adoption of a measure which they regard as hostile to the public interest and injurious to the national character." The bill was never called up.³³ In the Senate it was proposed to impose a similar tax of one-half of 1 per cent and return the

²⁴ *Congressional Globe* (38th Cong., 1st sess.), pp. 3183-85. Statements of Messrs. Sweat, Hooper, Ganson, Kernan, Hotchkiss, and Noble.

²⁵ *Ibid.*, pp. 3186-87, 3217, 3351. The margins of defeat were very small.

²⁶ *Ibid.*, pp. 3184-86. Statements of Messrs. Malory, Allen, and Stevens.

²⁷ *Ibid.* (38th Cong., 2d sess.), pp. 351-53, 1198-99. Mr. Holman admitted that one reason he so ardently opposed exemption was his belief that the agricultural community which he represented could not benefit from the exemptions.

²⁸ *Ibid.* (39th Cong., 1st sess.), p. 1435.

²⁹ *Ibid.*, pp. 1452, 1455, 1614.

³⁰ 13 Stat. 425, sec. 1 (1865); 13 Stat. 469, sec. 2 (1865).

³¹ *Congressional Globe* (40th Cong., 2d sess.), pp. 1177 and 2753.

³² *Ibid.*, p. 3588.

³³ *Ibid.*, p. 3689, and *ibid.* (40th Cong., 3d sess.), p. 843. Representative Ashley also introduced a bill to tax at 10 per cent (see *ibid.* [40th Cong., 2d sess.], p. 4001).

amounts to the states where collected, but the proposal was not accepted.³⁴

Mr. Holman was so confident that the Congress would impose the special withholding tax on federal security income that he proposed to exempt that income from the regular levy in the income-tax bill of 1869.³⁵ This proposal rekindled the political fire which apparently had burned rather fiercely over this issue during the previous political campaign. Mr. Stevens stated that the Republicans of his state, New Hampshire, had made equalization of taxation a platform issue and promised that "the holders of the bonds of the United States should pay their share of the public burdens."³⁶ Mr. Benjamin added that "we all know very well that this bond question, this question of taxing the national securities, was discussed from every stump throughout the length and breadth of this land."³⁷ Mr. Holman amended to impose a 10 per cent tax, but none of his proposals was accepted.³⁸

An unsuccessful attempt was made during the first session of the Forty-first Congress to use the unpopularity of the taxes upon salt, tea, coffee, sugar, matches, and tobacco to gain the end sought when a bill to remove the taxes on the items named had appended to it a 2½ per cent tax in gold on "all bonds heretofore and hereafter issued."³⁹

The states tried repeatedly to subject federal securities to their taxes but were repulsed by the courts. In 1867 Kentucky adopted a new form of income tax, one applicable only to income from United States bonds. For a time this method of taxation yielded considerable

revenue but was declared unconstitutional in 1872.⁴⁰ Virginia also tried to tax the interest from federal securities. By 1870 Texas had dropped all her income tax except that on bonds, and that lapsed in 1871.⁴¹ In 1870 the Virginia law was amended to include interest from state and local securities, including her own.

PRESSURE TO LOWER THE INTEREST RATES ON BORROWED FUNDS AND TO REDUCE THE FEDERAL DEBT (1869-94)

In 1870 the cry in Congress, following the usual postwar pattern, was "down with the taxes." It was pointed out by the Senate Finance Committee that lowering of taxes involved two things: the reduction of the existing interest on the federal debt and the spreading of the debt over a long time period.⁴² It was also stated by the committee that "the second purpose of the bill [refunding act of 1870] is to satisfy in the only way possible the popular discontent against the non-taxation of bonds." The method proposed was to fund the debt at "an interest equal to the income from active capital diminished by the average rate of taxation." It seemed in the judgment of the congressional leaders at that time that the bonds would have to be tax exempt in order to sell at the lower interest rates⁴³ when there existed a feeling

⁴⁰ *Laws of Kentucky, 1867*, Vol. I, chap. 1832; also *Bank of Kentucky v. Commonwealth*, 9 Bush 46.

⁴¹ *Laws of 1870*, chap. 84, sec. 32. The Confederacy also imposed income taxes during the Civil War. The 1863 law, for instance, levied a tax on "... and the income and profits derived from any source whatever except salaries."

⁴² *Congressional Globe* (41st Cong., 2d sess.), p. 378.

⁴³ It was proposed to refund the current 6 per cent bonds with 5 per cent-twenty-year, 4½ per cent-thirty-year, and 4 per cent-forty-year securities.

³⁴ *Ibid.* (40th Cong., 2d sess.), pp. 3999 and 4037.

³⁵ *Ibid.* (40th Cong., 3d sess.), p. 841.

³⁶ *Ibid.*, p. 843. ³⁷ *Ibid.*

³⁸ *Ibid.*, pp. 842, 845, 1277.

³⁹ *Ibid.* (41st Cong., 1st sess.), p. 336.

that there was discrimination in favor of foreign held bonds which were not taxed.⁴⁴ It was merely a matter, they explained, of "getting most for the federal government."⁴⁵

Secretary of the Treasury Boutwell in his first report on the finances on December 6, 1869, had described the manner in which he proposed to fund the outstanding debt. While apparently he favored exemption, he left the matter open to Congress. He stated what he considered to be the essential conditions of a new loan:

That the bonds, both principal and interest, shall be free from all taxes, deductions, or abatements of any sort, unless it shall be thought wise to subject citizens of the United States to such tax upon income from the bonds as is imposed by the laws of the United States upon income derived from other money investments.⁴⁶

The opponents of exemption asked "why put upon the statute books anything as obnoxious as this which will really effect so little," since the only tax which could be applied was the income tax, and it would "go soon."⁴⁷

In spite of one motion to recommit the bill with instructions including no exemptions,⁴⁸ and another motion to strike out section 4 containing the exemption clause,⁴⁹ the bill passed, providing exemption from all existing forms of taxation:

All of which said several classes of bonds and the interest thereon shall be exempt from the payment of all taxes or duties of the United States, as well as from taxation in any form by

or under State, municipal or local authority; and the said bonds shall have set forth and expressed upon their face the above specified conditions.⁵⁰

The act was amended on January 20, 1871,⁵¹ and again on January 14, 1875.⁵² Both amendments provided for "like exemption" to that in the parent act. Likewise, the bonds authorized in the Act of March 3, 1875, were to be "of the character and description" set out in the Act of July 14, 1870.⁵³ Too, the Act of January 25, 1879, authorizing the redemption of outstanding 5-20's, maintained the existing exemptions.⁵⁴ On June 28, 1902, the act authorizing bonds to finance the Panama Canal was approved. These bonds have the same exemption clause as that contained in the 1870 act.⁵⁵

LEGAL CONSTRAINTS APPLIED AND THE SIXTEENTH AMENDMENT (1894-1913)

From 1870 to 1872 numerous bills and resolutions were introduced into Congress to repeal the federal income tax,⁵⁶ but that law was allowed to expire naturally in 1872. Federal taxation of security income therefore temporarily ceased. Those favoring this method of raising revenue did not let the matter rest, however. Between 1872 and 1894, scarcely a congressional session missed having bills and resolutions introduced

⁴⁴ *Congressional Globe* (41st Cong., 2d sess.), p. 1538.

⁴⁵ *Ibid.*, p. 1591.

⁴⁶ Bayley, *op. cit.*, p. 93.

⁴⁷ *Congressional Globe* (41st Cong., 2d sess.), Appendix, p. 135.

⁴⁸ *Ibid.*, p. 1758.

⁴⁹ *Ibid.*, p. 1877.

⁵⁰ 16 Stat. 272, sec. 1 (1870).

⁵¹ 16 Stat. 399, chap. 23 (1871).

⁵² 18 Stat. 296, chap. 15 (1875).

⁵³ 18 Stat. 466, chap. 134 (1875).

⁵⁴ 20 Stat. 265, chap. 24 (1879).

⁵⁵ 32 Stat. 484, sec. 8 (1902). This was supplemented by the Act of August 5, 1909 (36 Stat. 117, sec. 39), but the exemption feature remained the same.

⁵⁶ *Congressional Globe* (41st Cong., 3d sess.), pp. 20, 64, 143; *ibid.* (42d Cong., 1st sess.), pp. 53, 66, 75, 85; and *ibid.* (42d Cong., 2d sess.).

for the revival of the income tax.⁵⁷ Many of these proposals specifically stated that bond interest was to be taxed.⁵⁸

By 1894 the sentiment and pressure for a progressive form of taxation had grown to the point where the income tax was re-enacted. During the House debates it was proposed to amend the bill to include as income the interest on notes and bonds except where specifically exempted by law of their issuance in order that the "contracts" already made should not be broken.⁵⁹ When, later, New York's Senator Hill moved to strike out the clause exempting through "law of issuance," and added that the refunding bill had exempted bonds but not bond interest, he was accused of attempting to kill the bill. Mr. Hill then withdrew his first motion and substituted one to exempt state and local bond interest from the federal income tax. When his amendment was rejected by a vote of 25 to 30, he proposed to add only state bond interest to the other exemption. Although his third motion was defeated also (27 to 30),⁶⁰ he had succeeded in emphasizing the question of the constitutionality of the central government's taxation of the income from local security issues.⁶¹ This was an issue on which Congress wavered but on which the Supreme Court was unanimous. The 1894 income-tax bill providing that "in estimating the gains, profits, and income of any person there shall be

included all income derived from interest upon notes, bonds, and other securities, except such bonds of the United States the principal and interest of which are by law of their issuance exempt from all Federal taxation,"⁶² was doomed to a judicial death. On April 8, 1895, a part of it was declared unconstitutional,⁶³ and at a rehearing⁶⁴ on May 20 of the same year the whole act met the same fate. The judges at the first hearing agreed unanimously, however, that the section imposing a tax on state bonds was unconstitutional. Thus again state security income was free of federal taxation.

As Representative Hull said in a speech to Congress in 1909, but two methods were open through which the right to impose an income tax might be granted: to have the Supreme Court review the case or to have the states ratify a constitutional amendment.⁶⁵ The first method was tried repeatedly between 1895 and 1909,⁶⁶ but no bill ever passed beyond the committee stage. Many unsuccessful attempts to submit the matter to the states were also made⁶⁷ prior to

⁶² 28 Stat. 553, sec. 28 (1894). A 2 per cent tax was levied on incomes over \$4,000. President Cleveland did not sign the bill.

⁶³ *Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429.

⁶⁴ 158 U.S. 601.

⁶⁵ *Congressional Record* (61st Cong., 1st sess.), pp. 4400-4405.

⁶⁶ 55th Cong., 1st sess., H.R. 3499; 2d sess., H.R. 10001, 10150; 60th Cong., 1st sess., H.R. 345, 10548, 16084, 21216; 2d sess., H.R. 28439; 61st Cong., 1st sess., H.R. 110, 111, 1473.

⁶⁷ 54th Cong., 1st sess., S.R. 35, H.Res. 82, 200; 55th Cong., 1st sess., S.R. 14, 47, H.Res. 34, 57, 65, 71; 2d sess., H.Res. 104, 191, 277; 56th Cong., 1st sess., S.R. 7, 12, 49; H. J. Res. 27, 61, 78, 99; 57th Cong., 1st sess., H. J. Res. 17, 44, 70, 73, 123, 140, 165; 58th Cong., 1st sess., H. J. Res. 1, 17, 27; 2d sess., H. J. Res. 67; 3d sess., H. J. Res. 211; 59th Cong., 1st sess., H. J. Res. 17, 20, 36; 2d sess., H. J. Res. 248; 60th Cong., 1st sess., S.R. 45, 80, H. J. Res. 7, 10, 42, 71, 177, H.Res. 241; 61st Cong., 1st sess., S. J. Res. 8, 25, 39, 40.

⁵⁷ During the first session of the Fifty-first Congress ten, and during the first session of the Fifty-second Congress twenty, different bills were introduced to tax income.

⁵⁸ See *Congressional Record* (43d Cong., 2d sess.), p. 1659; *ibid.* (45th Cong., 2d sess.), pp. 4691-92; *ibid.* (46th Cong., 3d sess.), pp. 401 and 578; *ibid.* (49th Cong., 1st sess.), pp. 893 and 2496.

⁵⁹ *Ibid.* (53d Cong., 2d sess.), pp. 1594, 1733, 1736, 1739.

⁶⁰ *Ibid.*, pp. 6784, 6804, 6810, 6820.

⁶¹ *Ibid.*, pp. 6806-19.

1909. When the Payne-Aldrich Tariff Act was under consideration, the Republicans successfully blocked the attempts which were made by Senators Cummins and Bailey to tack on an income-tax amendment.⁶⁸

But the income tax still represented one of the most acceptable methods for raising much-needed funds. Even President Taft, who in his campaign speeches had declared himself opposed to a constitutional amendment to provide for a federal income tax, reversed his stand and, while stressing the need of taking care of the "rapidly increasing deficit," advocated an inheritance tax, an excise tax on corporations, and the submitting of the income-tax amendment to the states, since these measures would not conflict with the Pollock decision.⁶⁹ The excise tax on corporations was passed⁷⁰ and was upheld by the Supreme Court in spite of the fact that the income from state and municipal bonds was included and taxed.⁷¹ The same Congress also agreed after lengthy debate to submit for state ratification the income-tax amendment to the Constitution.⁷²

The Sixteenth Amendment as submitted read: "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States and without regard to any census or enumeration."

On January 5, 1910, Governor Hughes asked the New York state legislature to

refuse to ratify the pending amendment, since the phrase "from whatever source derived" would make possible a claim by the federal government on any state property—even its bonds.⁷³

While Governor Hughes's opinions had always carried much weight, exception was taken to his views. Senator Root argued that the end sought could only be a "removal of the restrictions as to apportionment and not a change in the well-settled rule which restrains the national government from taxing State securities."⁷⁴ Senator Borah introduced a resolution requesting the Judiciary Committee to report whether or not the proposed amendment would authorize Congress to tax the income from state and municipal bonds. This resolution, however, was laid on the table.⁷⁵ Senator Borah very clearly explained his personal views on the subject when he declared:

First, . . . that the [taxing] power of the National Government at the present time is full, complete, unlimited and unfettered. . . .

Secondly . . . the words "from whatever source derived" add nothing to the force or strength of the amendment itself.

Third, the amendment did not deal, does not purport to deal, and was not intended to deal with the question of power. It . . . does deal alone with the manner of exercising that power which is already complete, that is already without limit.

He added that the limitation came not in the taxing power but in the reconciliation of that power in a dual system of government where each part is sovereign within itself.⁷⁶

⁶⁸ *Congressional Record* (61st Cong., 1st sess.), pp. 1351, 1420, 2457, 3137-38, 2443-45, 4061, 4228.

⁶⁹ *Ibid.*, p. 3344. The Democrats charged that the Republicans were using this method to avoid a tax on incomes, since it was likely that more than twelve states would refuse to ratify the amendment.

⁷⁰ 36 Stat. 112, sec. 38 (1909).

⁷¹ *Flint v. Stone Tracy Co.*, 220 U.S. 107 (1911).

⁷² S. J. Res. 40 (61st Cong., 1st sess.).

⁷³ *Congressional Record* (64th Cong., 1st sess.), pp. 1171-72.

⁷⁴ *Senate Document* 308 (61st Cong., 2d sess.).

⁷⁵ S.R. 175 (61st Cong., 2d sess.).

⁷⁶ *Congressional Record* (61st Cong., 2d sess.), pp. 1694-99. See also William E. Borah, "The Income Tax Amendment," *North American Review*, CXCI (June, 1910), 755-64, and Harry Hubbard, "From Whatever Source Derived," *American Law Journal*, VI(b) (September, 1920), 220-27.

Senator Brown, who had introduced the resolution for the amendment, agreed with Mr. Borah's interpretation that no new power to reach incomes was granted.⁷⁷ Professor Seligman also took issue with Governor Hughes. He expressed the belief that, while the Sixteenth Amendment did not extend the power of the federal government to tax the income of state and municipal bonds, there were valid reasons why constitutional interpretation should keep pace with changing political and social conditions.⁷⁸

Senator Borah also tried to attach an income-tax amendment to the 1912 revenue bill in which the exemption of interest from state, local, and federal securities (when exempt by law of their issue) was specified.⁷⁹

By February, 1913, a sufficient number of states had ratified the Sixteenth Amendment to append it to the Constitution.⁸⁰ The way was open again to impose a federal income tax. Congress lost little time in so doing. The 1913 House bill exempted state and local security income, but that from federal securities was made tax free only for those issues specifically freed by previous legislation.⁸¹ The Senate amendment to give the United States security income the same blanket exemption as that of local governments, however, was accepted.⁸² The law even mentioned state securities first: "that in computing net gains under this section, there shall be excluded the interest upon the obligations

of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions."⁸³

WORLD WAR I CONDITIONS INTENSIFY THE PROBLEMS (1914-18)

About this time Europe was beginning to suffer from depressed economic activity and was also boiling with international political disturbances. Our own customs receipts, affected by these conditions, were falling. "Preparedness" and later entry into the war, on the other hand, called for increased expenditures. It was inevitable, therefore, that internal revenue taxes as well as borrowing would increase. Income-tax rates accordingly began to climb. The normal rate for individuals and corporations, which had been 1 per cent in 1913, reached 12 per cent by 1918. Surtaxes, too, were scaled to unprecedented highs; between 1913 and 1918 maximum rates progressed from 6 to 65 per cent.⁸⁴ Estate taxes were also increased, and excess-profits taxes imposed. Borrowing was on a scale never before equaled.

The problem of allowing tax exemption for security income to exist simultaneously with the mounting level of the tax rates and the volume of tax-exempt bonds outstanding was certainly sensed during the war period but was usually dominated by other needs which seemed far more pressing while prosecuting the war.

The 1916 income-tax act left full exemption and added the provision for the Federal Farm Loan securities which had been authorized⁸⁵ by specifying freedom

⁷⁷ *Congressional Record* (61st Cong., 2d sess.), pp. 1649, 1699, 2245-47.

⁷⁸ Seligman, *op. cit.*, pp. 596-628.

⁷⁹ *Congressional Record* (62d Cong., 2d sess.), pp. 9533, 9680, 9708.

⁸⁰ See announcement of Senator Brown, February 3, 1913, in *ibid.* (62d Cong., 3d sess.), p. 2480.

⁸¹ *Ibid.* (63d Cong., 1st sess.), p. 1237.

⁸² *Ibid.*, p. 3850.

⁸³ 38 Stat. 168, Sec. II (b) (1913). This act was declared constitutional on January 24, 1916, in *Brushaber v. Union Pacific Railroad Co.*, 240 U.S. 1 (1916).

⁸⁴ See Tables 15 and 16 in the Appendix for a complete tabulation of these tax rates.

⁸⁵ 39 Stat. 380, sec. 26 (1916).

from taxation for "interest upon the obligations of a State or any political subdivision thereof or upon obligations of the United States or its possessions or securities issued under the provisions of the Federal Farm Loan Act of July Seventeenth, nineteen hundred and sixteen."⁸⁶

In June, 1917, the First Liberty Loan bonds were issued. Representative Hull pointed out that "many would prefer a reasonable tax rate on these securities" but that he felt that "a small rate should be imposed in the beginning."⁸⁷ More interest, however, was manifested in our being assured of mutual exemptions from the Allies to whom loans were to be made.⁸⁸ With slight deviation, the prevailing exemption practice was accepted, and the bonds were made exempt "from all taxation, except estate or inheritance taxes, imposed by authority of the United States, or its possessions, or any State or local taxing authority."⁸⁹

It was later admitted, however, that the magnitude of the financial burden incurred by the war necessities was not comprehended when the First Liberty Loan was authorized.⁹⁰ By the time the Second Liberty Loan Act was being considered, Treasury officials, working with the members of the Ways and Means Committee, decided that the base of ownership of the bonds should be spread. In order to do this, it was proposed to raise the former $3\frac{1}{2}$ per cent interest rate to 4 per cent and to make the bond interest subject to the surtaxes.⁹¹ In the House the increase in

rates was questioned, since it was pointed out that the end of the war would bring lowered surtaxes.⁹² It was also felt by some that the prevailing practice regarding exemptions should be maintained, particularly when state and local bonds were exempt.⁹³ Mr. Hull said that he feared that the change might cause the outstanding exempt bonds to gravitate to the wealthy and later added that "few greater evils could arise than the entire exemption of our public debt growing out of the war."⁹⁴ Mr. Cannon's proposal to exempt the first \$5,000 of holdings in order to "protect the small investor" was accepted.⁹⁵ The Second Liberty Bond Act therefore provided that holdings of less than \$5,000 were to be exempt, but holdings of \$5,000 or over were to be subject to the surtaxes.⁹⁶

The 1917 income-tax act therefore specified exemption for

the interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States (but, in the case of obligations of the United States issued after September first, nineteen hundred and seventeen, only if and to the extent provided in the act authorizing the issue thereof) or its possessions or securities issued under the pro-

⁹² *Ibid.*, p. 6573.

⁹³ *Ibid.*, pp. 6579 and 6694.

⁹⁴ *Ibid.*, p. 6693, Appendix, pp. 565-66. Mr. Hull stated that, while he thought the wealthy were during the last few days stocking up "on state and municipal issues," he believed that it was "not wise policy to allow forty-eight states to impose varying tax rates on federal securities," and it was questionable "whether the federal government should undertake to impose taxes on State and local bonds unless fiscal conditions should make it a matter of last resort."

⁹⁵ *Ibid.*, pp. 6706 and 7180. Mr. Hull wanted to specify exemption for \$200 interest, but his amendment was rejected in favor of Mr. Cannon's to exempt \$5,000 principal.

⁹⁶ 40 Stat. 291, sec. 7 (1917). The holdings of less than \$5,000 were still subjected to the estate and inheritance taxes, while holdings of \$5,000 or over were exempt from the normal tax only.

⁸⁶ 39 Stat. 758, sec. 4 (1916).

⁸⁷ *Congressional Record* (65th Cong., 1st sess.), Appendix, p. 83.

⁸⁸ *Ibid.*, pp. 634 and 636.

⁸⁹ 40 Stat. 35, sec. 1 (1917).

⁹⁰ *Congressional Record* (65th Cong., 2d sess.), p. 10439.

⁹¹ *Ibid.* (65th Cong., 1st sess.), pp. 6572-73.

visions of the Federal Farm Loan Act of July seventeenth, nineteen hundred and sixteen. . . .⁹⁷

By the time the Treasury was asking for funds from the Fourth Liberty Loan, it faced the problem not only of marketing the new issue but of bolstering to par the prices of the second and third loans. Since the exempt bonds of the First Liberty Loan were then selling at a premium, it was concluded that tax exemption was responsible for the price differentials.⁹⁸ The Treasury proposal to exempt up to \$30,000 of the fourth loan and to allow up to one and one half times this exemption for holders of the other loans if they were also subscribers to the new loan was accepted by the Senate Finance Committee. In spite of the argument that this privilege would discriminate against the small investor and against the person who invested most of his funds in earlier loans, the exemption clause was enacted.⁹⁹ It was also ex-

⁹⁷ 40 Stat. 329, sec. 1200 (1917). It was also specified that corporations and individuals were not permitted to deduct interest on "indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt."

⁹⁸ On September 18, 1918, Mr. Reed stated in the Senate that only a few days before the First Liberty Loan bonds because of being nontaxable were quoted at 102½, while the Third were at 97½ and the Second at 95. He explained the differential between the prices of the latter two loans as being due to the difference in interest rates. Economists, however, in discussing this contention, pointed out that, while exemption was a factor accounting for price differentials, the distribution of the bonds among different kinds of investors as well as the sizes of the issues no doubt also had effect (see J. E. Kirshman, *Principles of Investment* [Chicago: A. W. Shaw & Co., 1924], pp. 362-63).

⁹⁹ Additional exemptions which were provided by the Victory Loan Act and by the Revenue Act of 1921 made the aggregate amount of First Liberty Loan converted and other Liberty loan bonds exempt from the surtaxes for any one investor \$160,000 up to 1923, \$55,000 in 1924, 1925, and 1926, and \$5,000 after 1926 (40 Stat. 844, chap. 142 [1918]; 40 Stat. 965, sec. 1 [1918]; 40 Stat. 1310, sec. 18[b] [1919]; and 42 Stat. 317, sec. 1328 [1921]).

plained by the Senate Finance Committee chairman that, while the exemption was expected to be "quite an inducement" for large and small investors to purchase the bonds, it was only one method employed by the Treasury to bring the prices to par. It was also argued that the 4½ per cent interest rate was allowed in order to encourage conversion of the First Liberty Loan bonds, which could not "ever be taxed," to those of the Fourth Liberty Loan, whose tax specifications could be changed after the war.¹⁰⁰

The feeling was common that the fully exempt state and local bonds competed unfavorably with the taxed federal bonds. It was stated that the Secretary of the Treasury "very strongly advocated the taxing of municipal bonds in order that the liberty-bond market might not be interfered with."¹⁰¹ The House members therefore seized the opportunity. The Ways and Means Committee wrote into the 1918 income-tax bill a tax on income from state and local securities like the levy imposed on federal war issues.¹⁰² When House members questioned whether such action would be constitutional, Mr. Kitchen explained that the only way to examine the proposal was to incorporate it in a bill and that this was the proper time to do it, since no one expected it to be tested until after the war.¹⁰³ Mr. Parker moved to make the Farm Loan bonds subject to the same taxation as the Liberty bonds, but he withdrew his amendment when the Treasury attitude on that subject was made clear. Representative Montague

¹⁰⁰ *Congressional Record* (65th Cong., 2d sess.), pp. 10436-40.

¹⁰¹ *Ibid.*, p. 10373.

¹⁰² *House Report 767* (65th Cong., 2d sess.), p. 9.

¹⁰³ *Congressional Record* (65th Cong., 2d sess.), pp. 10165, 10361-75, Appendix, p. 674.

offered an amendment to prevent the taxation of bonds of the states and their municipalities, but his amendment was rejected to accept the proposal of the Ways and Means Committee.¹⁰⁴

The Senate Finance Committee, however, refused to uphold the House action and deleted the section taxing the state and local security income. The opinions in the Senate at that time seemed as varied as they have been since. Mr. Jones proposed an amendment to limit individual or corporation exemption of interest on state and municipal bonds to that from a principal amount of \$5,000. Mr. Kellogg objected that this would subject income from such sources to the normal as well as the surtaxes, but, more important, that the bonds were issued under specific conditions that they would not be taxed by the federal government. Mr. Thomas argued that if the federal government could tax state securities, states could tax those of the federal government. Mr. Knox thought that war powers vested Congress with that right, but, now that the war was over, the matter was purely an academic one. Mr. Underwood believed in maintaining the existing status.¹⁰⁵ When the 1918 income-tax act was passed, it left the full exemption as provided in the previous acts.¹⁰⁶

¹⁰⁴ *Ibid.*, pp. 10372-75, 10409-11.

¹⁰⁵ *Congressional Record* (65th Cong., 3d sess.), pp. 774-77.

¹⁰⁶ 40 Stat. 1065, sec. 213(b) (1919). This act exempted "interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation: . . . In the case of obligations of the United States issued after September 1, 1917, and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the re-

POST-WORLD WAR I EFFORTS TO REDUCE TAX EXEMPTION (1919-24)

By the time the first World War ended in November, 1918, tax exemption was a live issue, and attention, no longer diverted by war emergencies, was focused on the problem. The extraordinarily high surtax rates coupled with a volume of some thirty billion dollars of securities outstanding whose income was either wholly or partially exempt immediately became a major concern with governmental leaders and laymen.

Secretary of the Treasury Glass in his 1919 annual report¹⁰⁷ and Secretary Houston in 1920¹⁰⁸ urged elimination of the tax-exempt privilege. Secretary Glass proposed a plan for taxing the income under existing laws. His scheme was to have the taxpayer compute his tax in such a way that the exempt portion would fall at the lower instead of the upper end of the surtax brackets.¹⁰⁹ The plan apparently received more attention on the outside than within legislative circles.

President Harding in his first message

spective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt from taxation to the taxpayer. . . ."

¹⁰⁷ *Annual Report of the Secretary of the Treasury* (Washington: Government Printing Office, 1920), pp. 24-25.

¹⁰⁸ *Annual Report of the Secretary of the Treasury* (Washington: Government Printing Office, 1921), p. 38.

¹⁰⁹ John F. Thompson, "The Problem of Tax-Exempt Bonds," *Journal of Politics*, IV (August, 1942), 357-58. This plan has been objected to on the grounds that it would discriminate against the small investor. It has been pointed out that, while a person with a \$20,000 income, one-half of which was taxable, would have his taxes increased over threefold, a \$500,000 income person with one-half of the \$500,000 taxable would have his levy increased only about one-third (see D. Kelly, "Suppose Municipal Bonds Are Taxed," *Barron's* [November 22, 1937], p. 19).

to Congress recommended the adoption of a constitutional amendment to eliminate exemptions.¹¹⁰ In 1920 the Chamber of Commerce of the United States by a referendum vote of 1,386 to 275 adopted a recommendation against issuing further tax exemptions.¹¹¹ The National Tax Association also condemned continuance of tax-free interest on securities.¹¹²

On April 30, 1921, the Secretary of the Treasury, Andrew Mellon, in a letter to the chairman of the Ways and Means Committee, recommended to Congress that "it consider the advisability of taking action by statute, or constitutional amendment where necessary, to restrict further issues of tax-exempt securities." Again, on September 23, 1921, Mr. Mellon declared:

The ever-increasing volume of tax-exempt securities represents a grave economic peril, not only by reason of the loss of revenue which it entails to the Federal Government, but also because of its tendency to encourage the growth of public indebtedness and to divert capital from productive enterprises. The issue of tax-exempt securities has a direct tendency to make the graduated Federal surtaxes ineffective and nonproductive because it enables taxpayers subject to surtaxes to reduce the amount of

¹¹⁰ *Congressional Record* (67th Cong., 2d sess.), p. 39. President Harding declared: "I think our tax problems, the tendency of wealth to seek nontaxable investments, and the menacing increase of public debt, Federal, State, and municipal—all justify a proposal to change the constitution so as to end the issue of nontaxable bonds."

¹¹¹ Chamber of Commerce of the United States, *Referendum No. 34* (Washington, December 17, 1920). The committee stated that it wanted to "record its strong conviction . . . that there should be no exemption of any future issues the income from which may lawfully be made subject to tax." The vote was taken upon the statement: "Income from any new issues of securities which may lawfully be made subject to federal tax should be taxable."

¹¹² Resolution adopted at thirteenth annual conference on taxation, held September 10, 1920. Resolution reaffirmed at fourteenth annual conference (see *Proceedings of National Tax Association* [New York: National Tax Association, 1922], pp. 485-94).

their taxable income by investing it in such securities, and at the same time the result is that a very large class of capital investments escape their just share of taxation.¹¹³

These arguments of the Secretary were rephrased and repeated many times during the course of the public hearings before the Ways and Means Committee on January 16-19 and March 7, 1922, by representatives of the American Economic Association, the Investment Bankers' Association, the United States Chamber of Commerce, the American Farm Mortgage Bankers' Association, the National Association of Real Estate Boards, and the United Gas Improvement Company. Many of the industrial representatives, confident that a sympathetic attitude toward their borrowing problems prevailed, discussed freely the unfair competition which they felt they faced when interest rate differentials due to exemptions existed in favor of governmental units. Telegrams were also received by the Ways and Means Committee from twenty-eight state governors, of whom fifteen favored elimination of exemptions, six opposed it, and seven were noncommittal.¹¹⁴

During this period of aroused public interest, Mr. Green introduced into the House his joint resolution for a constitutional amendment to permit reciprocal taxation of security income. Since this resolution is typical of a large number of others which have been introduced through subsequent years, it is quoted:

The United States shall have power to lay and collect taxes on income derived from securities issued after the ratification of this article by or under the authority of any State, but without discrimination against income derived

¹¹³ *House Report 969* (67th Cong., 2d sess.), pp. 3-4.

¹¹⁴ *Hearings before the Committee on Ways and Means on Tax Exempt Securities* (Washington: Government Printing Office, 1922).

from such securities and in favor of income derived from securities issued after the ratification of this article by or under the authority of the United States or any other State.

SEC. 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued after the ratification of this article by or under the authority of the United States, but without discrimination against income derived from securities and in favor of income derived from securities issued after the ratification of this article by or under the authority of such State.¹¹⁵

Mr. Green stated that the resolution had been considered by the Ways and Means Committee for nearly a year and had been worked on for about six months in conjunction with Treasury attorneys.

The chief objection seemed to be that the adoption of such an amendment would raise the borrowing costs for the municipalities.¹¹⁶ Mr. Mellon in his letter of December 21, 1922, to the Ways and Means Committee, asserted:

Whatever opposition there is to the proposed amendment to restrict further issues of tax exempt securities rests, I think, upon a misunderstanding of the object and effect of the amendment, and this, in turn, harks back to the old controversies about State rights and the powers of the Federal Government. I can say without hesitation that, separated from these old prejudices and taken from the point of view of the facts as we have to face them today, the proposed constitutional amendment involves no question whatever of State rights and makes no attack whatever on the credit or borrowing power of the States or their political subdivisions. . . . The constantly growing mass of tax exempt securities threatens the public revenues, not only of the Federal government but of the States as well, and it is reaching such proportions as to undermine the development of business and industry.¹¹⁷

¹¹⁵ H. J. Res. 314 (67th Cong., 4th sess.). This resolution had also been introduced during the second session of the Sixty-seventh Congress, but it never passed committee stage at that time.

¹¹⁶ *Congressional Record* (67th Cong., 4th sess.), pp. 705-29.

¹¹⁷ *Ibid.*, p. 1316.

The numerous amendments to Mr. Green's resolution were all rejected, and the original proposal was accepted by the House by a vote of 223 to 101.¹¹⁸

The resolution was then referred to the Senate Judiciary Committee, and a subcommittee of that body held public hearings on the proposal on February 10, 17, and 22, 1923. Many of the same persons appearing before the Ways and Means Committee pleaded for elimination of exemptions also before the Senate Committee. Resolutions and memorials from nine states also urged the submitting of the amendment to permit the taxation of security income. On the other side, however, some very vehement statements were made which attempted to discredit the Treasury arguments, to label the House passage only a "Lame Duck achievement," and to show that insufficient thought and consideration had been given the proposal.¹¹⁹ The joint resolution was never reported to the Senate for action. The Senate did, however, pass a resolution directing the Federal Trade Commission to investigate the "facts relative to tax-exempt income from government securities."¹²⁰

On January 10, 1924, Mr. Green again introduced his resolution for an amendment into the House.¹²¹ Amend-

¹¹⁸ *Ibid.*, p. 2284.

¹¹⁹ *Hearings before a Subcommittee of the Committee on the Judiciary on H. J. Res. 314* (Washington: Government Printing Office, 1923). See particularly the statements of Mr. Warren Wall, attorney for the State Tax Board of Virginia. The nine states asking for the amendment were Arkansas, Iowa, Minnesota, Nebraska, North Dakota, Ohio, Oklahoma, Oregon, and South Dakota.

¹²⁰ S. Res. 451 agreed to February 28, 1923. Report of the Federal Trade Commission is contained in *Senate Document 148* (68th Cong., 1st sess.).

¹²¹ Mr. Green's attitude toward the importance of his proposal was expressed in his statement that this "strikes at an evil which is certain, if not checked, to eventually undermine the foundations

ments to the resolution to limit the time for ratification, to allow the government to restrict the holdings of exempt securities by any individual, and to tax outstanding as well as future issues were rejected. The pleas that the wealthy were escaping their just share of the tax burden, supported by examples of Mr. Wrigley's \$3,000,000 and Mr. William Rockefeller's \$43,000,000 invested in tax-exempt bonds, did not offset the strong opposition to the resolution. It was charged that the proposal to eliminate exemption was backed by Wall Street moneylenders; that the bankers' associations wanted curbs placed on low money rates afforded farmers through the Federal Land banks; and that the public utilities did not like the competition they were receiving from municipal ownership of utilities and therefore wanted local borrowing costs raised.¹²² Mr. Green's amendment failed to get its two-thirds majority in the House.¹²³

Almost ten years later, Mr. Green, who was then a judge in the United States Court of Claims, said, when discussing this failure to get his resolution through the House:

The bill was supported by the Treasury. . . . Had it received a fair degree of support from the Southern states, it would have had the necessary majority in the House and probably would have been adopted by the Senate.

It may seem strange that such opposition should exist in the South, where comparatively small amounts of tax-exempt securities are held, but the Southern states, as a rule, are large borrowers and their representatives were moved by the argument that they could borrow

money cheaper if permitted to issue tax-exempt securities.¹²⁴

It is true that, of the 101 votes cast against the Green resolution, 72, or almost three-fourths, came from southern state representatives.¹²⁵

Newspaper comments have also borne out the belief that the fear of increased local governmental borrowing costs was the strong force in defeating Mr. Green's proposal. The *St. Paul Pioneer* stated that "the opposition sprang from sources which feared that the various units of government would have trouble raising funds if the tax-exempt feature were abolished." The *Wall Street Journal*, discussing the same subject, said: "In the long run, the additional public revenues to be realized in this manner will be largely and perhaps wholly offset by the higher cost of public borrowing." That paper went on to say, however, that, "even so, the burdens of government would probably be more equitably distributed and certainly tax revenues would be given something of the stability that governmental interest charges already have."¹²⁶

The same session of Congress which rejected the Green proposal saw many other attempts made to eliminate exemptions. Representative Frear presented a

¹²⁴ William R. Green, "Tax Exempt Securities," *New Republic*, LXXI (June 8, 1932), 102-3.

¹²⁵ The 101 negative votes were distributed among the southern states (72) as follows: Alabama, 6; Arkansas, 3; Florida, 2; Georgia, 4; Kentucky, 1; Louisiana, 7; Mississippi, 7; Missouri, 1; North Carolina, 8; Oklahoma, 1; South Carolina, 6; Tennessee, 3; Texas, 15; Virginia, 7; and West Virginia, 1; among the others (29): Arizona, 1; California, 4; Connecticut, 1; Illinois, 2; Indiana, 2; Maryland, 3; Michigan, 1; Montana, 1; New Jersey, 4; New York, 3; Ohio, 1; Pennsylvania, 4; Rhode Island, 1; and Vermont, 1.

¹²⁶ *Washington Star*, March 20, 1934, p. A-8, reviewed the question and quoted the papers referred to above.

upon which our institutions rest and bring the whole mighty edifice down in utter ruin" (see H. J. Res. 136 [68th Cong., 1st sess.]).

¹²² *Congressional Record* (68th Cong., 1st sess.), pp. 2002, 2091, 2133-50.

¹²³ The vote was 247 to 133.

plan to tax outstanding securities. His bill was so phrased that the Supreme Court could not disqualify its provisions except by a vote of eight to one. Mr. Frear submitted the plan to Secretary Mellon, who condemned it as unsound and unfair and requested that it be dropped. The Secretary's advice was not heeded, but the amendment was not given favorable action. Mr. Black also suggested that all interest on holdings in excess of \$5,000 should be included in gross income and taxed. Mr. Oliver countered with a constitutional amendment to give Congress power to tax securities issued after ratification and to return to the states the revenues so collected. Neither proposal was accepted, however. Mr. Reed and Mr. Walsh also tried to put through amendments to tax income from future issues of federal and local securities but without success.¹²⁷

Stephen Davis, solicitor of the Department of Commerce, suggested another solution to the problem. He sent a memorandum upholding the constitutionality of the proposal that tax-free securities found in estates and inheritances be taxed at penalty rates. Secretary of Commerce Hoover sent it to Chairman Smoot of the Senate Finance Committee, but the plan apparently never received serious consideration from the Senate Finance Committee or the House Ways and Means Committee.¹²⁸

President Coolidge renewed President Harding's recommendation concerning tax exemption.¹²⁹ When on June 2, 1924,

he signed the Revenue Act, he objected to five features of the bill, one of which was the failure of Congress to pass a resolution to abolish tax-free income. Enough resolutions certainly had been introduced to accomplish this purpose. Between December 28, 1920, and February 19, 1924, sixteen different proposals for an amendment had been introduced, but only the two discussed above succeeded in getting beyond the committee of reference.¹³⁰

THE PROSPERITY ERA OF THE 1920'S AN ERA OF ACQUIESCENCE (1924-30)

By the middle twenties the intensity of interest in eliminating tax exemption began to subside. This was probably due in part to the discouraging effect of the failure to get Congress to approve the proposals, in part to the fact that the surtax rates were being lowered, and in part to changing business conditions.¹³¹

While Secretary Mellon had been stressing the necessity for elimination of tax-free interest, he had raised a much more emphatic appeal to have the surtax rates lowered. The Secretary had argued that the heavy surtaxes could be justified only as a war measure, that their effect was to make taxpayers seek escape in tax-exempt securities instead of in-

Coolidge said: "Another reform which is urgent in our fiscal system is the abolition of the right to issue tax-exempt securities. The existing system not only permits a large amount of the wealth of the Nation to escape its just burden but acts as a continual stimulant to municipal extravagance. This should be prohibited by constitutional amendment."

¹³⁰ See Table 14 in the Appendix for a list of these resolutions.

¹³¹ Mr. Hardy's study published about this time might also have carried weight in dispelling the feeling that government revenues were lost through the existence of tax-exempt bonds (C. O. Hardy, *Tax-Exempt Securities and the Surtax* [New York: Macmillan Co., 1926]).

¹²⁷ *Congressional Record* (68th Cong., 1st sess.), pp. 2718-26, 2854-56, 8200-8216.

¹²⁸ *Hearings before the Committee on Finance* (68th Cong., 1st sess. [Washington: Government Printing Office, 1924]), Appendix, pp. 438-44. A large part of this appendix is devoted to statements of college professors on the subject of tax-exempt securities.

¹²⁹ *Congressional Record* (68th Cong., 1st sess.), p. 97. In discussing the fiscal conditions, President

vesting in industry, and that the net result was loss of capital for business and loss of initiative by businessmen.¹³²

With regard to the lowering of taxes, the Secretary's plea had effect. The 1921 Act reduced the existing 65 per cent surtax maximum to 50 per cent. The 50 per cent was then lowered to 40 per cent in 1924 and to 20 per cent in 1926, and there it remained until 1932. Individual normal taxes during the same period had been successively dropped from 12 to 8 to 6 per cent, then to 5 per cent, and in 1929 to 4 per cent.¹³³ Personal exemptions were also raised, and an "earned income" credit was allowed for the first time in 1924. Corporation normal rates were slightly increased during this period from a low of 10 per cent in 1918 to a maximum of 13½ per cent in 1926, but in 1922 the excess-profits tax was allowed to die, and corporation normal rates fell to 11 per cent in 1929. Also estate taxes were made less severe, and the gift tax was repealed outright.

But the tax-exemption privilege was not changed. In addition to exemption specified in previous bills, the later income-tax acts provided:

In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit) and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented.¹³⁴

¹³² *Annual Report of the Secretary of the Treasury* (Washington: Government Printing Office, 1923), p. 8.

¹³³ See Tables 15 and 16 in the Appendix for a complete listing of these rates.

¹³⁴ 42 Stat. 238, sec. 213(b)(4) (1921). The only Ways and Means Committee amendment relative to this act which was not adopted by the House was one to appoint a committee to study tax-exempt securities. Senator LaFollette's amendment to levy an additional estate tax on securities which had not been subject to income taxes was defeated (see

During the latter half of the twenties agitation for elimination of exemptions rapidly declined. Even the opposition of the Treasury at that time, if existent, was certainly at a low ebb. Undersecretary Mills said that the effective time for passage of such an amendment had probably passed; that, of approximately \$16 billions of wholly-exempts outstanding, almost three-fourths were state and local; that since these securities were being issued at the rate of about a billion a year, such a large amount would be outstanding free of taxation before an amendment could become effective.¹³⁵ The point was even made that the federal government was at a disadvantage in marketing its own securities with states and municipalities and that Congress should consider authorizing the Treasury to make future issues wholly exempt.¹³⁶

THE GREAT DEPRESSION AND NEW ATTEMPTS TO TAX SECURITY INCOME BY STATUTE (1931-39)

The low in tax rates and in opposition to tax exemption had been achieved at the peak of prosperity in the late twenties, but, as the national debt and taxes mounted in the thirties, agitation against tax exemption began to rise again.

The federal government attempted by means of public spending to offset the greatly reduced incomes due to the widespread unemployment accompanying the major depression of the early thirties. The period of the thirties, there-

Congressional Record [67th Cong., 1st sess.], pp. 6646, 7490-98). Since 1910 the postal department has accepted deposits from the public. Interest from the bonds has been exempt. Total deposits in recent years have run over a billion dollars.

¹³⁵ Speech to stockholders of the Federal Reserve Bank of Boston, November 11, 1927.

¹³⁶ *Annual Report of the Secretary of the Treasury* (Washington: Government Printing Office, 1929), pp. 89-90.

fore, was one of deficit financing, of a constantly mounting federal debt, and of increasing tax rates. The gross debt of the federal government and its agencies increased from \$17.9 billion in 1930 to \$53.1 billion by 1940. The 1932 income-tax law raised the maximum surtax rate from its 1931 low of 20 per cent to 55 per cent. That rate was increased to 59 per cent in 1934 and to 75 per cent in 1935, at which level it remained until 1941. The individual normal tax maximum reached 8 per cent in 1932 but was dropped back to 4 per cent in 1934. Personal exemptions reached new lows. The 1932 act even eliminated the earned-income credit, but it was later restored. The maximum corporate normal tax went back up to $13\frac{3}{4}$ per cent in 1932, in 1935 it was boosted to 15 per cent, and by 1940 it was up to 19 per cent for some types of corporations.¹³⁷ Estate taxes were also raised. The maximum tax of that form was made 45 per cent in 1932 and 70 per cent in 1935. The gift tax was also reinstated.

With rates at these levels, a great interest began to be manifested in "the existing tax avoidance." On January 21, 1933, a memorial signed by 101 university economists was sent to congressional committees, the President, and the President-elect, urging them to eliminate tax-exempt securities.¹³⁸

During the first session of the Seventy-third Congress, Senator Clark introduced an amendment to the National Industrial Recovery Act that, effective January 1, 1933, the income of bonds of the United States, its possessions, of any state, territory, or political subdivision thereof, or of the District of Columbia was to be taxed. His amendment also

provided for the reporting of information with regard to the volume of Farm Loan securities held. Senator Clark was of the firm conviction that the Sixteenth Amendment had overruled the Pollock decision and that Congress could impose the tax. The Clark amendment was accepted by the Senate by a vote of 45 to 37.¹³⁹

When the Conference Committee failed to act on the amendment which had passed, Senator Clark called for an explanation. He declared that the Senate conferees should represent the sentiments of that body instead of their own personal views. He further charged that the statement had been "made on the floor of the House in debate . . . on conference report that the amendment having to do with tax exempt securities had not been taken to conference because the Senate conferees receded before the conference met."¹⁴⁰ Senator Harrison, leader of the Senate Conference Committee, replied that he had not known Senator Clark was "really so earnest about this tax-exempt proposal." He further justified the action by saying that the

Senator will recall that not a word was spoken upon the floor of the Senate in opposition to the amendment. I had assumed that this body would not accept an amendment which might be retroactive in character, which sought to have the government impose a tax on tax-free municipal, state and county bonds. I just assumed that the Senate would not stand for that proposal at all, because I could envision, if such an amendment should be enacted, the little towns in my state [Mississippi] and all the States of this country, being unable to finance them-

¹³⁷ See Tables 15 and 16 in the Appendix for a complete list of the rates imposed.

¹³⁸ *Editorial Research Reports*, I (1933), 61.

¹³⁹ *Congressional Record* (73d Cong., 1st sess.), pp. 5420-21. Twenty-nine states were represented by the 37 negative votes. With the exception of Ohio and Mississippi, all the states having both their votes and noses were in the northeastern section of the United States.

¹⁴⁰ *Ibid.*, p. 5857.

selves in the future because they could not sell any such bonds.

Senator Harrison further explained that "the Treasury Department informed the conference that they had just sold \$900,000,000 of bonds," which were to be delivered the following Thursday, that the bonds were advertised to be sold with the tax-exempt features included, and that if this provision remained in the bill and was enacted, it would destroy the sale of the bonds; the Treasury was already receiving telegrams from everywhere because of the adoption of this amendment. The Conference Committee report was then accepted by a vote of 46 to 39.¹⁴¹

Senator Clark proposed his same amendment again during the second session of the Seventy-third Congress. He explained that one purpose of the amendment was to "close loopholes" and that another was to "put taxation of the federal government on a firm foundation." When Senator McKellar's proposal to remove from the scope of the Clark amendment the securities of states and their subdivisions was accepted, Senator Clark withdrew his amendment with the explanation that its purpose had been defeated.¹⁴²

Mr. Ashurst agreed with the purpose of Senator Clark, he said, but disagreed with his statutory method. It was his belief that a constitutional amendment was necessary to tax local security income. Therefore, in January, 1934, he introduced a resolution for such an amendment identical to the one passed by the House in 1923. Secretary Morgenthau recommended the adoption of the resolution. It was favorably reported by the Senate Judiciary Committee on

April 17, 1934, but it did not come to a vote.¹⁴³

In the first session of the Seventy-fourth Congress, Senator Ashurst renewed his plea for a constitutional amendment.¹⁴⁴ Mr. Borah amended to tax the income from future issues of federal securities only. He explained that he did not believe that an amendment would be adopted during his lifetime but that there was no question of power of the federal government to tax its own securities. The Borah amendment was almost the only noncommittee one adopted while the 1935 Revenue Act was under consideration. The Conference Committee, however, deleted the proposal. In discussing the rejection by the Conference Committee, Mr. Borah charged that "the instruction of the Chamber [Senate] was given to the conferees to insist upon the amendment and we understood that it was used simply as a trade. . . . All that this amendment contributed [was a] trading point. [It was never] discussed on its merits."¹⁴⁵

The Treasury at that time was conditionally opposed to taxing the income from future issues of federal securities, as was expressed in a letter of March 6, 1934, to the chairman of the Senate Finance Committee. It was stated that "the Department is compelled to oppose the enactment of legislation which would eliminate the tax-exempt feature of

¹⁴³ *Ibid.*, pp. 60-61, 676-86, 6562, 6696, and *Report No. 738* on S. J. Res. 7.

¹⁴⁴ *Congressional Record* (74th Cong., 1st sess.), pp. 10159-65.

¹⁴⁵ *Ibid.*, pp. 13240-45, 14498-99, 14961. The vote on Senator Borah's amendment was 40 to 39. Mr. Borah also declared: "I am convinced that except for . . . the tax-exempt bond the World War would not have been one-half as attractive to the rich. For there is nothing more attractive to the greedy and avaricious of this world than the munitions and war profits on the one hand and the asylum of the tax-exempt bond on the other."

¹⁴¹ *Ibid.*, pp. 5859-61.

¹⁴² *Ibid.* (73d Cong., 2d sess.), pp. 6561-72. The vote on the McKellar amendment was 38 to 27.

future issues of Federal obligations while State and local issues would continue to enjoy their constitutional immunity from Federal taxation. It is further believed that submission of a constitutional amendment should precede legislative action with respect to the tax-exempt status of future issues of Federal securities in view of the uncertainty as to the ratification of such an amendment by the States."¹⁴⁶

During this time a very loudly publicized "Share the Wealth" campaign was sweeping the country. Huey Long had formed his "Share Our Wealth: Every Man a King" organization; Dr. Townsend was advocating a \$200 per month old age pension plan; and Father Coughlin was broadcasting appeals for his "National League of Social Justice." Undoubtedly, all these cries did not go unheeded.

On June 19, 1935, President Roosevelt sent a message to Congress in which he said: "Our revenue laws have operated in many ways to the unfair advantage of the few, and they have done little to prevent an unjust concentration of wealth and economic power," to which Senator Long said "Amen."¹⁴⁷ Word later came from someone at the White House, however, that the President would not insist on a measure along the lines of his message but that he was anxious to have steps taken to permit the taxation of government securities.¹⁴⁸

¹⁴⁶ Treasury officials repeated again in letters to the chairman of the Senate Finance Committee on March 19, 1935, and to Senator Harrison on February 5, 1937, that they favored a constitutional amendment but that, in the absence of one, they opposed enactment of bills to tax the income of future issues of federal securities.

¹⁴⁷ R. G. Blakey and G. C. Blakey, *The Federal Income Tax* (New York: Longmans, Green & Co., 1940), pp. 366-72.

¹⁴⁸ *New York Times*, June 23, 1935.

When the Ways and Means Committee's 1937 revenue bill was presented to the House, it was explained that "the major purpose of this bill is to close loopholes in the revenue laws of which numerous taxpayers have availed themselves . . . to escape the share of the burden of taxation the Congress has intended they should bear." It is significant, therefore, that this measure made no reference to tax exempt securities.¹⁴⁹ Mr. Borah said that he intended to amend to tax future issues of federal obligations but, seeing the tenor of the Senate, that he saw no reason to push his amendment.¹⁵⁰

It was President Roosevelt's message to Congress on April 25, 1938, which really broke the lull and heralded the storm which was to follow. The President came out boldly to end tax exemption of securities and salaries by means of a statute.

The sixteenth amendment to the constitution of the United States, approved in 1913, expressly authorized the Congress to "lay and collect taxes on incomes from whatever source derived." This is plain language. Fairly construed this language would seem to authorize taxation of income derived from State and municipal as well as Federal bonds.

. . . [The] courts followed a policy of reciprocal immunity.

Whatever advantages this reciprocal immunity may have had in the early days of this Nation have long ago disappeared.

. . . Both the State and the Nation are deprived of revenues which could be raised from those best able to supply them.

. . . therefore I lay before the Congress the statement that a fair and effective progressive

¹⁴⁹ *House Report 1546* (75th Cong., 1st sess.). The fact that tax exemption had been omitted was brought to the President's attention in a press conference. He said that he favored elimination of exemption but that he saw little hope of getting states to ratify an amendment.

¹⁵⁰ *Congressional Record* (75th Cong., 1st sess.), p. 6291, and H. J. Res. 375.

income tax and a huge perpetual reserve of tax-exempt bonds cannot exist side by side.

... I therefore recommend to the Congress that effective action be promptly taken to terminate these tax exemptions for the future.

... Such legislation can, I believe, be enacted by a short and simple statute. It would subject all future State and local bonds to existing federal taxes, and it would confer similar powers on States in relation to future Federal issues.¹⁵¹

Political opponents and those antagonistic to this taxation accused the President of "dictating to Congress" and "overlooking the courts and Congress."¹⁵² The Smaller Business Association, on the other hand, sent the President a telegram congratulating him on his stand and reminding him that "these were among the original recommendations to you by smaller business at the Washington conference."¹⁵³ President Butler of Columbia University went so far as to say that to adopt a new constitutional amendment to accomplish the purpose would make America "the laughing stock of the world."¹⁵⁴

A resolution was introduced into the Senate to establish a joint congressional committee on taxation of government securities and salaries. The resolution was reported back without amendment and ordered to lie on the table. On June 16, however, that body did adopt a resolution to establish a "Special [Senate] Committee on the Taxation of Government Securities and Salaries."¹⁵⁵

¹⁵¹ *House Document 603* (75th Cong., 3d sess.).

¹⁵² See article appearing in the *New York Herald Tribune*, copy of which is in *Congressional Record* (75th Cong., 3d sess.), Appendix, p. 1564.

¹⁵³ *Ibid.*, Appendix, p. 1754.

¹⁵⁴ *New York World Telegram*, September 25, 1937.

¹⁵⁵ *Ibid.* S. Con. Res. 36, and S. Res. 303. On May 24, 1939, S. Res. 135 was agreed to whereby this committee was continued through the first session of the Seventy-sixth Congress.

No doubt the President had been furnished the conclusion which the Department of Justice was soon to make public. A voluminous study had been made by that department completely covering the legal aspects of the tax-exemption problem. The conclusion was reached that the trend of court decisions had been such that an act of Congress taxing state and local as well as federal security income would probably now be sanctioned without the necessity of a constitutional amendment.¹⁵⁶

The constitutional and legal conclusions of this study were later sharply challenged in an extensive brief entitled *The Constitutional Immunity of State and Municipal Securities: A Legal Defense of the Continued Integrity of the Fiscal Powers of the States*. This brief was prepared by the attorneys-general of thirty-nine states and was submitted to Congress in 1939. The Joint Committee on Internal Revenue Taxation also prepared for the use of the 1939 committee considering the question a report entitled *Power of Congress To Tax the Interest from State and Local Securities*.

During the passage of the 1938 Revenue Act several senators tried to append amendments to tax security income. Mr. Borah again tried to have income of future issues of federal obligations taxed, but Mr. Clark wanted to include income from state and municipal securities as well. Senators Harrison and Barkley opposed the amendments on the grounds that if accepted they would seriously affect the floating of bonds for recovery purposes. In spite of the fact that these amendments were not favored by the Administration, Mr. Borah's was

¹⁵⁶ Department of Justice, *Taxation of Government Bondholders and Employees* (Washington: Government Printing Office, 1938). The study was transmitted to the Treasury on June 24, 1938.

accepted only to be thrown out again by the Conference Committee.¹⁵⁷

On January 19, 1939, President Roosevelt repeated his exhortation to Congress. "It is not unreasonable to hope that judicial decision would permit the elimination of these immunities," he said. "It is difficult for almost all citizens to understand why a constitutional provision permitting taxes on 'income from whatever source derived' does not mean 'from whatever source derived.'"¹⁵⁸

During January and February, 1939, the Special Senate Committee and during June and July of the same year the Committee on Ways and Means held public hearings. The House committee, however, restricted its discussions to tax-exempt securities, since an act imposing taxes on salaries of public employees had been accepted by the House on February 9 and by the Senate on April 14.¹⁵⁹

It was in these hearings that the storm of protest from the highly organized state and local officials became publicly evident. The Conference on State Defense grew out of the meeting of state attorneys-general in Washington on May 31, 1938. At that time it included among its active members representatives of seventeen states and a number from specifically constituted authorities such as the Port of New York Authority, the Delaware River Joint Commission, and the Triborough Bridge Authority.¹⁶⁰ The

¹⁵⁷ *Congressional Record* (75th Cong., 3d sess.), pp. 5175-83. Mr. Borah's amendment won by a vote of only 34 to 33; Mr. Clark's was rejected 23 to 41.

¹⁵⁸ *House Document* 113 (76th Cong., 1st sess.).

¹⁵⁹ *Hearings before the Special (Senate) Committee on Taxation of Government Securities and Salaries* (76th Cong., 1st sess. [Washington: Government Printing Office, 1939]); and *Hearings before the Committee on Ways and Means* (76th Cong., 1st sess. [Washington: Government Printing Office, 1939]).

¹⁶⁰ "Strong Opposition Developing to U.S. Taxing Exempts," *Wall Street Journal*, July 22, 1938, pp. 1 and 4.

Conference grew so rapidly, however, that, by the time the congressional hearings were being conducted, officials of most of the states and larger cities as well as many smaller ones were enrolled to oppose the elimination of exemptions. Also some seven thousand members of the National Conference of Mayors joined in the protest.¹⁶¹

During the course of the hearings, almost every person who represented the cities and states fervently opposed taxation of security income, while those representing the federal government or independent views argued for taxation of bond interest. The Treasury attitude was expressed by Secretary Morgenthau, who, when pleading for "taxation in harmony with economic recovery," asked for elimination of many "inequities and defects," one of the principal of which was tax-exempt securities.

On September 18, 1940, the Special Senate Committee majority report, concurred in by Senators Brown, Byrd, Miller, and Townsend, was submitted to the Senate. These senators stated:

There should be in our opinion no more tax-exempt bonds. Where an issue now outstanding may be refunded at lower interest rates because of the present low money market, we would permit a refunding with the tax-exemption now permitted the existing issue, limited as to final maturity date as were the original bonds. . . . We are unanimously opposed to any attempt to tax outstanding bonds of Federal, State or municipal governments, except insofar as they are taxable by their terms under the law and practice at the time of their original issue.¹⁶²

On the same date the minority report was submitted by Senator Austin for himself and Senator Burke. They declared:

¹⁶¹ *Congressional Digest*, XXI, No. 3 (March, 1942), 69.

¹⁶² *Senate Report* 2140 (76th Cong., 3d sess.), Part I, pp. 15-16.

We are of the opinion that this proposal is economically unsound and that it is unconstitutional. It is based upon a theory of tax evasion that is not supported by the facts. Though it has been popularized with the public as a device to obtain additional taxes from the wealthy, it would in reality place upon the States, and particularly upon the cities, a heavy burden of increased local taxation.¹⁶³

In discussing the report in the Senate, Mr. Brown attempted to call attention to the contrast between public and special group opinion on the issue by pointing out that the Gallup poll results had indicated that three-fourths of the American people favored the proposal to tax security interest and that, of seven hundred newspaper editorials on the subject appearing at the time of the President's speech and during the hearings, over six hundred had favored taxation. He further stated that if at the time of the adoption of the Sixteenth Amendment, levies of this nature had been permitted, "close to ten per cent of the income for the federal government would be derived from this source of taxation." Senator Austin in presenting the minority views based his arguments principally upon the cost-revenue and legal aspects of the problem.¹⁶⁴

On December 14, 1940, Senator Brown made his views concrete by proposing the "Public Bond Tax Act of 1940" as Title VI to the pending revenue bill. He explained that the amendment was offered for Senators Byrd, Clark, Lee, Miller, and himself. The amendment provided for reciprocal taxation of income from future issues of federal, state, and local governments and their instrumentalities. Outstanding issues refunded to obtain lower interest rates were to remain exempt provided the maturity dates were

not extended by the new issues. The Senate rejected the amendment 30 to 44.¹⁶⁵

The influence exerted by the organized groups opposing this taxation was strongly publicized at the time of the formulation and defeat of the Brown amendment. The *Christian Science Monitor* boldly stated:

Not for a long time, if ever, has so powerful a lobby representing the state governments appeared in Washington and it is supplemented by municipal law officers from many of the nation's largest cities. . . . The Institute of Municipal Law officers is bringing its full forces to bear to retain tax immunity for municipal securities.¹⁶⁶

Labor came forth with the statement:

A powerful lobby group—the Conference for State Defense—seems to have made headway in keeping the President's recommendation in cold storage. There is considerable sentiment against it in both the House Ways and Means Committee and the Senate Finance Committee.¹⁶⁷

The *Annalist* also asserted:

The Congressional decision to delay action on the taxation of future issues of Federal, State, and local obligations, despite the administration's assurances of Supreme Court acceptance of such a measure, indicates that strong political influence has been exerted to postpone action. Objections have not been centered about the aspects of equity, nor the effect of exemptions on the flow of investments, nor the amount of revenues to be collected, nor even the legal technicalities involved. Rather it has been around the cost of the elimination of exemptions to local and state governments that effective criticism has been centered.¹⁶⁸

¹⁶⁵ H.R. 10413 (*ibid.*, pp. 12185-92, 12304). Thirty-seven states were represented in the negative votes, but only seven states had both their senators vote "No."

¹⁶⁶ *Christian Science Monitor*, January 28, 1939, p. 1.

¹⁶⁷ "Officials' Lobby Losing Battle To Escape Income Taxes," *Labor*, February 28, 1939, p. 4.

¹⁶⁸ Harry N. Bulow, "Much Argument against Eliminating Tax-Exempt Bonds Based on False Premise," *Annalist*, LIV (October 26, 1939), 533.

¹⁶³ *Ibid.*, Part II, p. 1.

¹⁶⁴ *Congressional Record* (76th Cong., 3d sess.), pp. 12006-7, 12239-47.

From 1931 through 1939 ninety-four different resolutions were introduced into Congress to handle the problem of tax-exempt securities through a constitutional amendment.¹⁶⁹ Some would argue that indirect progress was made by the imposition of taxes on salaries of public employees, but, as far as the direct exemption of bond interest was concerned, the status at the end was much the same as it was at the beginning of the period.

FEDERAL GOVERNMENT TAXES FUTURE
ISSUES OF ITS OWN BONDS (1941—)

This country entered the forties with a national debt and tax rates higher than ever before and with all prospects pointing toward further increases, since a second world war was threatening, and expenditures for preparedness were again being called for. The gross national debt of the federal government and its agencies in 1940 was \$53.1 billions. By the end of May, 1946, the gross federal debt stood at \$272.6 billions. The maximum individual surtax rate, which was 75 per cent in 1940, climbed to 91 per cent by 1944. The individual normal rate was 6 per cent by 1942, while that applicable to some corporations was up to 24 per cent by 1941.¹⁷⁰ The corporate normal plus surtax rate reached 40 per cent, and a 95×90 per cent excess-profits tax was imposed. Congress was ready to take some action on tax-exempt income.

The Public Debt Act of 1941, as reported by the Ways and Means Committee, provided for the issuance of United States Savings Bonds in small denominations ("Baby Bonds") to appeal to small investors. The bill also completely removed the tax-exemption fea-

ture from all United States bonds and bonds of its agencies and instrumentalities, where such bonds were issued after March 1, 1941. It was explained by Chairman Doughton that the provision did not apply to bonds of the United States' possessions or territories or to those of the District of Columbia, since the functions of these units were similar to those of the states whose securities were not affected. He explained further that it had been estimated that the tax would eventually *net* the federal government from \$90,000,000 to \$100,000,000 annually of additional revenue and that the Treasury had estimated it would be necessary to increase the interest rates on long-term bonds only about one-eighth of 1 per cent and on short-term issues only one-fiftieth to two-fiftieths of 1 per cent, since it was expected that persons in all income classes would hold these bonds. Mr. Patman criticized the provision, calling it just a scheme to "get the camel's nose under the tent"; that alone it would not mean much but was only a step toward the taxing of state and local security income. He therefore moved to strike out Section 4, but his amendment was rejected. The House, however, seemed more concerned over the raising of the national debt limit to \$65 billion which a member dubbed "bunco for New Deal waste," than over the new tax provision.¹⁷¹ In the Senate, Mr. Connally questioned whether the Treasury would get back as much as it would pay out. When Mr. Wiley thought it would be a good idea to exempt the first \$5,000 to encourage holdings by "poorer investors," Mr. Brown reminded him that the Baby Bonds satisfied that need and that, if any exemption was made, it would be an entering wedge whereby the

¹⁶⁹ See Table 14 in the Appendix for a list of these resolutions.

¹⁷⁰ See Tables 15 and 16 in the Appendix for a complete list of these rates.

¹⁷¹ *Congressional Record* (77th Cong., 1st sess.), pp. 848-82.

proposal would be broken down. Mr. Lee said that he was sorry that state and municipal bonds were not included; that he thought it a step in the right direction; and that he supposed it necessary to take one step at a time.¹⁷² The bill was passed, and federal security income for all future issues was subjected to full federal taxation¹⁷³ for the first time since the period 1864-70.

The portion of the 1942 hearings on the Revenue Act of that year dealing with the taxation of securities, therefore, centered on state and local issues, although Secretary Morgenthau had altered his stand and argued for the taxing of income from outstanding issues of federal as well as outstanding and future issues of state and local bonds. In discussing "tax loopholes" before the Forum of the City Club of Cleveland on January 24, 1942, the Secretary had mentioned first tax-exempt securities. He stated:

No matter how much money may be needed for the war, no matter how high the tax rates may be for others, a taxpayer is not obliged to contribute anything in this hour of his country's peril, if only he can afford to lay his hands upon a sufficient amount of tax-exempt securities.

The Federal Government last year took a first step toward remedying this situation by stopping the issuance of tax-exempt Federal securities. Now that we are at war, now that the revenue needs of the Government have soared beyond all previous conceptions, it is high time, in my opinion, to tax the income of State and municipal securities, not only the income from future issues, but also the income from those issues now outstanding.¹⁷⁴

¹⁷² *Ibid.*, pp. 1007-15.

¹⁷³ 55 Stat. 9, sec. 4 (1941).

¹⁷⁴ *Hearings before the Committee on Ways and Means* (77th Cong., 2d sess. [Washington: Government Printing Office, 1942]), I, 8, 71. Mr. Morgenthau explained that, where tax-exemption clauses appeared in outstanding federal bonds, those promises could not be violated but that there was no moral commitment on the part of the federal government toward state and local securities.

Later, when discussing this change on Mr. Morgenthau's part, Senator Brown said that, while he declined to go along with the Secretary, he would concede the point that purchasers of outstanding issues of securities had not contemplated the existing level of surtax rates.¹⁷⁵

The personnel of the group appearing before the committee during the 1942 hearings dealing with the taxation of securities was almost the same as that present during the 1939 sessions.

The Senate Finance Committee presented the Revenue Act of 1942 with an amendment appended which provided exemption for income from state and local securities only if they were issued prior to January 1, 1943. Mr. Burton countered with an amendment to strike out the date, which would leave the existing exemption status. His reasons were that such a tax provision could not be defended as a war measure, since it would not raise revenues and would only increase local borrowing costs. Mr. Ellender also emphasized the same idea, saying that the uncertainties of federal interest rates in the future would cause local interest rates to "rise beyond reason." Mr. Burton and Mr. Ellender were strongly supported by Senators Austin and Connally whose chief arguments also centered on the cost aspects and on that of the breaking-down of intergovernmental immunities. Mr. Vandenburg pointed out, on the other hand, that war tax rates gave the wealthy investor "an increment [in value] increasing directly as a result of the war effort"; and Mr. Brown countered with the Department of Justice conclusions, among which was one as recent as April 14, 1942, contained in a letter written by Assistant Attorney-General Clark to Randolph Paul, tax

¹⁷⁵ *Congressional Record* (77th Cong., 2d sess.), p. 7904.

adviser to the Secretary of the Treasury, and from which Mr. Brown quoted:

We should like to reiterate, however, that the constitutionality of the proposed legislation does not depend exclusively upon the acceptance of our construction of the sixteenth amendment, namely, that the words "from whatever source derived" mean exactly what they say, and as so interpreted clearly embrace income from Government securities. With full confidence, the validity of our conclusion may rest upon the basic proposition previously discussed that no implied constitutional immunity from Federal taxation attaches to interest received from State and municipal obligations.

Mr. Clark explained that he would uphold the Treasury stand but that, of sixteen members of the Senate Finance Committee who were present, he was the only one who voted to consider taxation of outstanding issues. Mr. Burton's amendment was accepted, and the existing status of exemption for local security income was maintained.¹⁷⁶

Senator LaFollette, when discussing this Senate action later, declared: "For them [representatives of municipalities, counties, and states] to come here and attempt to overwhelm the Congress by their concerted drive against this proposal is to me a shocking indication that even in this dire hour of the Nation's necessity selfish interests and those who desire to retain special privileges are not conscious of the situation which confronts the people and their Government."¹⁷⁷

The Tax Institute summarized the situation well when it pointed out that "the fight is not a partisan one, nor does the active battle line appear to have been drawn as between economic classes. The determined antagonists of the move to end exemption are state and local

officials; the protagonists are federal officials and legislators. Investment and credit houses are staying rather close to the sidelines. Tax economists are almost unanimously in favor of ending the exemption and so are most laymen, but neither group has so far evidenced any desire to be militant."¹⁷⁸

The efforts which have been made since 1942 to achieve taxation of the income of exempt securities have been weak and ineffectual. Discussions of this subject were conspicuously absent from the hearings on the 1943 Revenue Act.¹⁷⁹ When Secretary Morgenthau, arguing for his requested "additional revenue and anti-inflationary" ten and one-half billions, suggested the possibility of a gain from stopping loopholes including tax-exempt securities, his statement was completely ignored by the Senate Finance Committee.¹⁸⁰

It appeared in 1943 that a side door might be opened whereby state bond interest might be taxed when the test case involving obligations of the New York Port Authority was tried before the Tax Court of the United States. The case arose over the fact that notices were sent to seven bondholders for deficiencies in not reporting Port of New York Authority bond interest on their March 15, 1938, income-tax returns. During the course of the trial in April, 1943, it was argued by the representatives of the Commissioner of Internal Revenue that the Port Authority was neither a state, a

¹⁷⁸ *Tax Policy* (Philadelphia: University of Pennsylvania), January, 1941, p. 2.

¹⁷⁹ The few mentions which were made may be found on pp. 482, 978, 983, 1003, and 1481 of the *Hearings before the Committee on Ways and Means* (78th Cong., 1st sess. [Washington: Government Printing Office, 1943]).

¹⁸⁰ *Hearings before the Committee on Finance* (78th Cong., 1st sess. [Washington: Government Printing Office, 1943]), p. 16.

¹⁷⁶ *Ibid.*, pp. 7888-7912, 7919-49. The vote on the Burton amendment was 52 to 34. Thirty-four states were represented in the 52 yeas votes.

¹⁷⁷ *Ibid.*, p. 8199.

territory, nor a political subdivision and that, therefore, interest from its bonds was not exempt under section 22(b)(4) of the income-tax act. However, the implications of the decision in a case of this kind were apparently fully recognized, since by far the major portions of the presentations by both sides were devoted to proving that state and local security income should or should not be taxed. The decision favoring the petitioner was appealed, but the higher court upheld the earlier decision, thus freeing from taxation the income from bonds of such agencies.¹⁸¹ On January 14, 1946, in the Saratoga Springs case, however, the Supreme Court reversed the lower-court decision and held that the federal government could impose an excise tax on the New York authority sales of mineral water.

It is possible, however, that the states might now accept, even support, the constitutional amendment method for taxing their security income, as is evidenced by the statement from the Conference on State Defense that "the Congress has been plagued with an issue that was constitutional in its scope and which should properly have been submitted to the people for decision. Had this course been followed it would have satisfied the states and recognized their rightful position in our constitutional system. The whole controversy could have been settled long ago. It is submitted that this is still the statesmanlike solution to the problem." On the other hand, it is questionable whether Congress would accept the type of amendment which the states might support.

Legislative enactments and court decisions have resolved the situation at

present into one in which states with very few exceptions exempt their own securities, those of their subdivisions, and those of the federal government but tax the issues of other states. In 1942 nine states out of thirty-two taxed the home-state securities, while twelve taxed home-state subdivision issues. All without exception taxed the securities of other states and those of their subdivisions.¹⁸² A tabulation of the state taxes of this nature in force in 1942 is shown in Table 1.

NONGOVERNMENTAL EXEMPTIONS FOR SECURITY INCOME

Some bondholders have been able to enjoy a measure of tax exemption because the corporations whose bonds they have held bargained to pay all or a part of the tax. The early tax-free covenant clauses often stated that holders would receive interest "without deduction from either interest or principal of this bond for any tax or taxes which said company may be required to pay or retain therefrom by any present or future laws of the United States or any State or subdivision thereof."

The early history of these tax-free covenants is hazy, but they might have been devised to dispel a prejudice which it was felt existed in the East, particularly in New England and probably in Pennsylvania, due to the fact that the bonds were taxed as personal property while stocks were not.¹⁸³ The first in-

¹⁸² In 1924 twelve states levied income taxes. By 1939 the number had increased to thirty-four, but by 1942 it had fallen back to thirty-two, owing to Ohio's and Tennessee's dropping from the group. The rates imposed by states have been consistently lower than those of the federal income taxes. No doubt these rate differences have played a part in the decisions of state and local governments to oppose federal efforts to impose reciprocal taxation.

¹⁸³ Donald Horne, "Your Taxes," *Banking*, XXXIII (July, 1940), 54-55.

¹⁸¹ See the case of *Shamberg v. Commissioner of Internal Revenue*, Docket No. 107713 (1943), Tax Court of the United States.

TABLE 1

TREATMENT OF INTEREST FROM FEDERAL, STATE, AND LOCAL GOVERNMENT OBLIGATIONS
UNDER STATE INDIVIDUAL INCOME TAXES, JANUARY 1, 1942

STATE	INTEREST FROM OBLIGATIONS OF:				
	Home States	Other States	Political Subdivisions of:		Federal Government and Agencies
			Home State	Other States	
Alabama.....	Exempt	Taxed	Exempt	Taxed	Exempt†
Arizona.....	Exempt	Taxed	Exempt	Taxed	Exempt‡
Arkansas.....	Exempt	Taxed	Exempt	Taxed	Exempt
California.....	Exempt§	Taxed	Exempt§	Taxed	Exempt
Colorado.....	Taxed	Taxed	Taxed	Taxed	Exempt¶
Delaware.....	Exempt	Taxed	Exempt	Taxed	Exempt
Georgia.....	Exempt	Taxed	Exempt	Taxed	Exempt¶
Idaho.....	Taxed	Taxed	Taxed	Taxed	Exempt‡
Iowa.....	Taxed	Taxed	Taxed	Taxed	Exempt¶
Kansas.....	Taxed	Taxed	Taxed	Taxed	Exempt¶
Kentucky.....	Exempt	Taxed	Exempt	Taxed	Exempt
Louisiana.....	Exempt	Taxed	Exempt	Taxed	Exempt¶
Maryland.....	Exempt	Taxed	Exempt	Taxed	Exempt
Massachusetts.....	Exempt§	Taxed	Exempt§	Taxed	Exempt
Minnesota.....	Exempt	Taxed	Exempt	Taxed	Exempt‡
Mississippi.....	Exempt	Taxed	Exempt	Taxed	Exempt
Missouri.....	Exempt	Taxed	Exempt	Taxed	Exempt
Montana.....	Taxed	Taxed	Taxed	Taxed	Exempt**
New Hampshire.....	Exempt	Taxed	Taxed§	Taxed	Exempt‡
New Mexico.....	Exempt	Taxed	Exempt	Taxed	Exempt
New York.....	Exempt	Taxed	Exempt	Taxed	Exempt
North Carolina.....	Exempt	Taxed	Exempt	Taxed	Exempt††
North Dakota.....	Exempt	Taxed	Exempt	Taxed	Exempt
Oklahoma.....	Taxed**	Taxed**	Taxed**	Taxed**	Exempt¶
Oregon.....	Taxed	Taxed	Taxed	Taxed	Exempt
South Carolina.....	Exempt	Taxed	Exempt	Taxed	Exempt
South Dakota.....	Taxed§	Taxed	Taxed	Taxed	Exempt
Utah.....	Exempt	Taxed	Taxed	Taxed	Exempt
Vermont.....	Exempt††	Taxed	Exempt††	Taxed	Exempt
Virginia.....	Exempt	Taxed	Taxed	Taxed	Exempt
West Virginia.....	Exempt	Taxed	Exempt	Taxed	Exempt
Wisconsin.....	Taxed	Taxed	Taxed	Taxed	Exempt‡

† United States obligation interest to be included in so far as the state is constitutionally or legally authorized to tax such income.

‡ Exempt by regulation.

§ Restricted to certain bonds issued before or after specified dates.

|| Excludes all income which the state is prohibited from taxing under the Constitution or laws of the United States.

¶ Law excluding taxing of United States bond interest recently repealed.

** No specific exemption in statute or regulation.

†† Exemption conditional upon obligation of North Carolina or of its political subdivisions being exempt from United States income taxes.

‡‡ Exempt when rate of interest does not exceed 5 per cent per annum.

Source: Division of Tax Research, Treasury Department.

stance of a corporation bond with this provision to be listed on the New York Stock Exchange seems to have been that of the Manhattan Railway consolidated 4 per cent bond of 1990, which was issued in 1890.¹⁸⁴ It was not, however, until the income tax seemed inevitable in the period preceding 1913 that borrowers, in their desire to make their offerings of funded securities as attractive as possible by throwing safeguards about the income of bondholders, turned their serious attention to the possibilities of the tax-free clauses. The stimulus for such a movement was given great impetus in 1901, when the bondholders of the newly formed United States Steel Corporation were offered this form of tax exemption from possible future income taxes. By the time of the passage of the 1913 income-tax law, it was estimated that approximately 70 per cent of the outstanding corporate bonds contained tax-free covenants.¹⁸⁵ The practice had become so prevalent that the clauses were included in standard forms of bonds prepared for the guidance of corporate management.¹⁸⁶

Such a broad clause as that stated above is not, as a rule, included in indentures and/or bonds now issued, but it occurs frequently in obligations issued prior to 1918. The scope of tax-free covenant clauses now included is generally definitely defined. Frequently, indentures provide simply that the company will pay interest without deduction for any federal income tax that it may be required to withhold, not exceeding 2 per cent.

¹⁸⁴ "Tax-Free Bonds Poor Insurance against New Income Tax," *Analyst*, XII (July 22, 1918), 75.

¹⁸⁵ Roy C. Osgood, "The Effect of Taxation on Securities," *Annals of the American Academy of Political and Social Science*, LXXXVIII (March, 1920), 164.

¹⁸⁶ Horne, *op. cit.*

The borrowers' obligations with respect to the federal income taxes is usually limited to the 2 per cent, and the application of the clause to state taxes often is restricted to certain states mentioned in the clause and limited in each instance to a specified rate.¹⁸⁷ Examples of the state taxes sometimes covered are the Pennsylvania corporate loans tax, the Connecticut four-mills tax on securities, and the Massachusetts income tax. The amounts of state taxes assumed usually far exceeds the federal 2 per cent. The covenants in some bonds assume as much as \$8.00 per bond. The advantages, however, are usually available only to residents of the state levying the tax, since nonresidents are not subject to the tax.¹⁸⁸

The 1918 Revenue Act, raising the normal rate over 2 per cent and providing for collection from the bondholders rather than issuers, stated that borrowers promising to pay taxes would be required to withhold 2 per cent of the federal income tax from the interest due the bondholders.¹⁸⁹ The Revenue Act of 1934 restricted the requirement to bonds issued prior to January 1, 1934.¹⁹⁰ Although the issuing company may not pay any federal income tax on bonds issued after January 1, 1934, when held by United States citizens, it may agree to refund up to 2 per cent or any other amount. Refunding of income tax (except such portion as the obligor might have agreed to refund in excess of 2 per cent) is not possible in case of issues prior to January 1, 1934, as the law requires

¹⁸⁷ *Moody's Manual of Investments, Railroads* (New York: Moody's Investors Service, 1943), pp. a80 and a81.

¹⁸⁸ Horne, *op. cit.*

¹⁸⁹ 40 Stat. 1072, sec. 221(b) (1918).

¹⁹⁰ 48 Stat. 723, sec. 143 (1934).

the obligor to withhold 2 per cent, even if bonds contain agreements to reimburse the holder for any portion of the tax.

SUMMARY

The question of tax exemption for governmental securities faced those who laid the cornerstones for fiscal policies in the United States. Secretary of the Treasury Hamilton opposed any tax on governmental issues, but his opinion was not universally accepted. The first extant record of tax exemption explicitly stated in a governmental loan contract appeared in the Antwerp Loan of 1791.

The question assumed greater proportions, however, with the inception of the Civil War federal income tax in 1861. Since that time federal security interest has gone through the stages of being partially taxed, fully taxed, wholly exempt, and partially taxed and wholly exempt by the central government. Since the states' attempts to impose levies on federal bond interest have always been repulsed, federal security income has been completely free of that form of taxation.

State and local bond interest was subjected to full federal income taxes previous to the ratification of the Sixteenth Amendment but has been wholly exempt since that time. It has been subject to state income taxes, however, where such have been imposed.

Agitation for the abolition of tax exemption for security income has been greatest during periods of high tax rates and at the times when large amounts of tax-exempt securities have been outstanding. Following the first World War, serious attempts were made to eliminate the exemption for security interest but without success. Such action at that time

was advocated by Treasury Secretaries Glass, Houston, and Mellon, by Presidents Harding and Coolidge, by the Chamber of Commerce of the United States and the National Tax Association, as well as by other influential groups. In 1923 a resolution for a constitutional amendment to achieve that end was accepted by the House but never went beyond committee hearings in the Senate. A similar resolution was defeated by the House in 1924. With the "prosperity era" of the late twenties came debt reduction, lowering of taxes, and a subsiding of tax-exemption elimination fervor. However, with the increasing debt and soaring of tax rates in the thirties, attention was turned again to "tax avoidance." The opinion that taxation of governmental income could be achieved through statute without resort to a constitutional amendment was also becoming more widespread. The Senate accepted in 1933 the provision appended to N.I.R.A. to allow reciprocal taxation for security interest, but the Conference Committee failed to act on the amendment. The Conference Committee also deleted in 1935 and in 1938 proposals accepted by the Senate to tax the income of future issues of federal bonds. However, the Senate declined to accept the Public Bond Tax Act of 1940 which represented the majority report and which provided for reciprocal taxation, but it did concur with the House in 1941 to make the interest on all future federal issues subject to full taxation by the central government. In 1942 the Senate again refused to tax the income of future local issues.

The Supreme Court has not had the issue squarely before it since the *Pollock v. Farmers' Loan and Trust Company* case in 1894. The trend of more recent

decisions of the Court on tangential issues seems to be toward drawing lines of demarcation between those functions of local governments which are taxable and those which are immune.

Beginning about 1890, corporations began to include in their bonds promises to pay at least a part of the income taxes which were or might be imposed on the income from such securities. These

tax-free clauses appear with far less frequency today than formerly. Corporations cannot now make payments in excess of 2 per cent of income taxes to the federal government for a bondholder if the security in question was issued prior to January 1, 1934, but may make refunds for the tax paid by the bondholder himself if the security was issued after January 1, 1934.

CHAPTER IV

ANALYSIS OF YIELD DIFFERENTIALS: WHOLLY EXEMPT VERSUS FULLY TAXABLE BOND INTEREST

HIGH-GRADE BONDS

PREVIOUS to 1941, two major problems faced the person attempting to deal with tax exemption for security income; one was the problem of whole exemption and the other that of partial exemption.¹ However, after the passage of the 1941 Revenue Act making all future federal bond income fully taxable, the problem of partial exemption has taken a subordinate position. The primary consideration now is that of wholly exempt state and local issues contrasted with the fully taxable federal and corporate securities. It is this problem, therefore, with which this chapter will deal. The minor question will be considered in chapter v.

The problem of whole exemption will be attacked through quantitative techniques, and the results of these measurements will then be used in the qualitative analyses to follow. It is proposed, first, to determine the relative yield² differentials between bonds wholly exempt and bonds fully taxable. The next step will be to examine the relative influences of fac-

tors which may affect the sizes of the yield differentials obtained.

The yield differentials (X_1).—If yields of fully taxable bonds are to be compared with the yields of wholly exempt bonds, the bonds being compared should be matched with respect to security, duration, marketability, callability, convertibility, and other special privileges, i.e., they should parallel each other in all respects except the tax feature. While it is recognized that federal taxable bonds probably would more nearly match the high-grade wholly exempt municipal bonds, the short period of time during which the former have been issued prevented their use. For these federal taxable bonds, therefore, the highest-grade corporate bonds have been substituted.

The nineteen corporate bonds which maintained Aaa ratings³ throughout the twenty-three-year period 1919-41 were selected. One of these bonds had to be dropped later, however, due to the fact that it could not be matched with a corresponding municipal bond.⁴ In addition, twenty-three bonds which fell only slightly short of the twenty-three-year continuous Aaa ratings⁵ were also chosen, thus making a total of forty-one corporate bonds used in the analyses. Only the yields of years rated Aaa were used.

These corporate bonds were matched

³ Moody's Investors Service ratings were used throughout in order to maintain comparability.

⁴ The chief difficulty encountered in matching this bond was due to its high 6 per cent coupon rate.

⁵ Out of the 529 total years rated for this group of bonds, 65 years were Aa and 20 were A. In no case was the rating below A.

¹ The terms "whole exemption" and "partial exemption" as used herein follow their conventional meanings. For federal securities: wholly exempt bonds are free from federal normal, excess-profits, and surtaxes and from state income taxes but subject to estate, inheritance, and gift taxes; partially exempt bonds are free from normal and excess-profits taxes but subject to surtaxes, estate, inheritance, and gift taxes. For state and local bonds: wholly exempt bonds enjoy the same freedom from federal taxation as the federal wholly exempt issues and from state income taxes, providing the taxing unit so rules.

² Yields were used in preference to prices, since yields are a function of the terms, prices, and coupon rates of the bonds.

with forty-one municipal bonds paying identical interest rates and in no case varying in maturity dates by more than two years if the bond had less than twenty-two years to run to maturity. No attempt was made to correct for these differences in maturity dates.⁶ Both the corporate and the municipal bonds were noncallable. It was necessary in some cases, however, to use serial municipal bonds in order to obtain the highest-rated securities to match the corporate bonds. New York state bonds which matched the corporates were selected first, Massachusetts state bonds second, and Pennsylvania state bonds third. These made up twenty-six of the forty-one bonds used. Baltimore, Maryland, supplied seven; Watertown, New York, five; Binghamton, New York, two; and Springfield, Massachusetts, one of the remaining ones. New York and Massachusetts bonds were rated Aaa throughout the entire period. In no year did the ratings of any bond used fall below Aa,⁷ and these years were excluded in the computations.⁸

Monthly bid and ask prices for the twenty-three years were obtained for each of the eighty-two bonds where prices were available. The bid prices were then converted into yields to ma-

⁶ As Macaulay points out, "if the 'duration' of a bond is not too short, increases or decreases of a few years in the 'time to maturity' affect the yield only negligibly. And of course, yields could (at least theoretically) be corrected by a statistically-derived equation relating yield to duration. Practically, any such correction is dangerous" (Frederick R. Macaulay, *The Movement of Interest Rates, Bond Yields and Stock Prices in the United States since 1856* [New York: National Bureau of Economic Research, 1938], p. 68).

⁷ Binghamton had two years, Watertown one year, Springfield one year, Baltimore five years, and Pennsylvania six years rated Aa. All others were Aaa.

⁸ Yields of the corresponding matched bonds were also excluded.

turity. In cases in which yields instead of prices were quoted, yields corresponding to bid prices were employed. It was necessary to use bid, since both bid and ask figures were not always available.⁹ Annual averages of the monthly yields were then obtained for each bond for each of the twenty-three years. Arithmetic means were used for this purpose. Unweighted arithmetic means of all the yields of bonds which were rated Aaa, which had corresponding Aaa yields in their mates, and which had at least ten years to maturity were then computed for each year. It might be argued on first thought that the amounts traded or the amounts outstanding should be used to weight these bond yields when a combined index for them was being constructed. Both of these weighting systems were discarded, however, because they would give undue consideration to those bonds which were shifted often and would place at a disadvantage the more seasoned bonds which tended to appear on the market with less frequency than the newer bonds. Weighting by the amounts outstanding would have introduced an element which was later to be studied as an independent variable.

The average corporate yield for each year was then expressed as a percentage deviation from the average municipal yield for the corresponding year. Relative rather than absolute deviations¹⁰ were employed, since it was felt that, when yields were high, a difference of

⁹ Bid prices (or yields corresponding to bid prices) were used in order to maintain comparability. An average of bid and ask prices might have been preferable, particularly at the bottom of the depression, had it been possible to secure both these figures. For a further discussion of this point see below, pp. 47-48.

¹⁰ Readers who are interested in absolute differences in these yields in order to make comparisons with previous discussions on this subject will find a further treatment below, p. 47.

any given absolute amount would not have the same appeal to an investor as a change of the same absolute amount at a low status of yields. The use of relative deviations also tends to minimize the effects due to the falling pure rates of interest. The two derived yield series are given in Table 2 and their relative differentials are shown on Figure 1.

During the early twenties, investors were paying for the state and municipal

argued that tax exemption was totally responsible for these observed differentials, it is believed that, owing to the nature of the controls exercised in the selection of the data, tax exemption was an important determinant. The possible influences of other factors will be discussed in a later section.

Of equal importance with the size of the premiums paid to secure the municipal wholly exempt high-grade bonds over

TABLE 2

AVERAGE ANNUAL YIELDS OF THE FORTY-ONE HIGH-GRADE CORPORATE AND OF THE CORRESPONDING STATE AND MUNICIPAL BONDS, 1919-41

YEAR	BOND YIELD		YEAR	BOND YIELD	
	Corporate	State and Municipal		Corporate	State and Municipal
1919.....	5.34	4.20	1931.....	4.50	3.72
1920.....	5.92	4.54	1932.....	5.26	3.96
1921.....	5.82	4.70	1933.....	4.65	3.69
1922.....	5.08	4.09	1934.....	4.06	3.20
1923.....	5.07	4.05	1935.....	3.50	2.73
1924.....	5.00	4.00	1936.....	3.22	2.57
1925.....	4.84	3.97	1937.....	3.27	2.62
1926.....	4.73	3.98	1938.....	3.21	2.29
1927.....	4.55	3.91	1939.....	2.96	2.06
1928.....	4.50	3.92	1940.....	2.88	1.90
1929.....	4.79	4.20	1941.....	2.82	1.61
1930.....	4.63	3.97			

bonds prices sufficiently high to make the yields of the corresponding corporates 25 to 30 per cent higher than those of the local government bonds. By 1929, however, this margin had narrowed to 14 per cent, but in the early thirties it again climbed toward 30 per cent. Following 1932 the yields of both series fell rapidly, but the yields of the municipals¹¹ declined so much more precipitously that by 1940 the relative prices of corporates were at a level which produced yields on the average one and one-half times those of the municipals. While it would not be

¹¹ The term "municipals" includes both state and city securities.

corporate high-grade fully taxable bonds is the question of the factors which may have affected the sizes of these premiums. The investigation of this question was based on the hypothesis that the level of surtax rates coupled with the level of taxable income is one of the strongest influences affecting the demand for tax-exempt securities, that the amounts of these bonds outstanding form the chief supply factor, and that returns from alternative investments compete with the desire for tax exemption. Among the alternative investments, stock prices furnished a measure of the force of the appeal for speculative as well as longer-

term investment opportunities, while the amounts of corporate flotations of new capital issues supplied a measure of the competition for equity capital. The uses made of each of these factors are discussed below.

The demand factor—level of surtax rates (X_2).—It was assumed that the higher

classes were used as weights. These weights were used on the assumption that an investor's desire to eliminate his tax burden would be in direct proportion to the amount of taxes which he paid above the critical point. In using this mathematically computed critical point and the system of weights employed, it

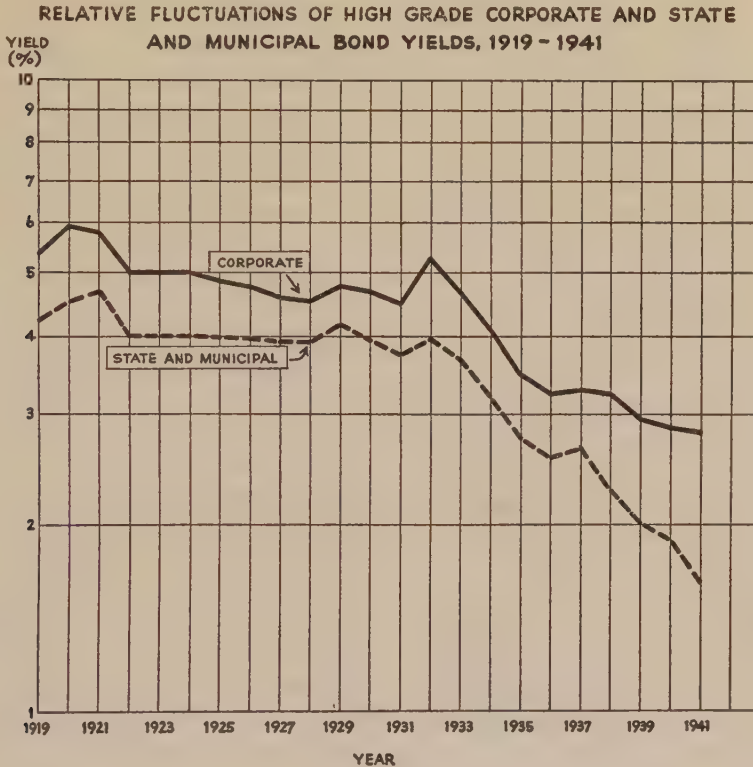


FIG. 1

the income-tax rates and the greater the taxable income, other things being equal, the greater the premium investors would be willing to pay to obtain exemption. Therefore, there was computed for each year the surtax rate level or "critical point" at which an investor began to gain from exemption. Then a weighted average surtax rate was computed for rates above this level. The amounts of taxes paid by the different income-group

was assumed that investors always act logically and rationally and that their decisions depend solely on the relatively greater financial returns. Market experience certainly does not always bear out these assumptions, but under the circumstances the procedure used seemed preferable to the alternatives.

The supply factor—amounts of tax-exempt securities outstanding (X_3).—The amount of state and local issues out-

standing on June 30 of each year for the period considered was used. The secular trend was rather pronounced in this series. An attempt was made to remove its influence on the results, however, by using deviations of the observations from a trend curve fitted to the data. For this purpose the Gompertz curve $\log Y_c = 4.33753 - .83851(.88976)^x$ was employed. The amounts of federal wholly tax-exempt issues were excluded, owing to the fact that those now outstanding are rather unique and are in many respects not comparable to those securities included in the municipal group.

*Alternative investment factors—stock prices (X_4) and amounts of corporate new capital flotations (X_5).—*How strong the incentive must be to cause an investor to forgo tax exemption for the sake of other returns is a complex question, the answer to which must involve many variables. No doubt, alternative investment returns are considered. Among the important competitors for investment capital would be common stocks and corporate financing needs.

As a measure of the first alternative, a common-stock price index has been employed. A stock price index took preference over one of yields or dividends, since the latter two reflect the investor's attitude toward longer-run investments but may not sensitively reflect his attempts at short-run gains as do stock prices.

The second alternative investment factor was restricted to new corporate capital flotations for two reasons. First, refunding capital does not always represent completely new outlays on the part of investors; and, second, the immediate problem is one involving corporate and municipal bond relationships.

*Relationships among these factors.—*The question now arises as to how the

factors selected were associated. The five sets of data on which were based the analyses to determine the associations among the factors are presented in Table 3 and as time-series curves in Figure 2.

In establishing a hypothesis for the nature of the relationships expressed by the general equation

$$X_{1c} = f(X_2) + f(X_3) + f(X_4) + f(X_5),$$

the relationships of the dependent variable to the independent ones appeared in preliminary analyses to be of the hyperbolic or parabolic type. Logically, one would scarcely expect linear relationships among these factors, since the increment of return from tax exemption would probably increase at an increasing rate after a certain level of surtaxes was reached. This behavior would be expected both from the nature of the tax rate structure and from the character of the income distribution curve. Likewise one would expect the desire for tax exemption to decrease at a decreasing rate as the alternative returns from common stocks increased or as the anticipations for returns from corporate capital investments mounted. These decisions of judgment were borne out by the preliminary analyses of the data. The hypothesis which seemed to express the existing relationships most favorably and which was finally chosen was that of

$$X_{1c}^x = a + b_{12.345}X_2 + b_{13.245}X_3 + b_{14.235}X_4 + b_{15.234}X_5.$$

The year 1941 was dropped in the final analyses. While the observations for this year followed the general patterns very well, it was feared that their extreme distances from the other observations probably reflected a war-seething economy rather than normal causes and should not be permitted to influence the results.

Some idea of the correlation existing

between X_1^* and X_2 , while X_3 , X_4 , and X_5 were held constant, and of the residuals of X_1^* on the other factors can be seen from the regression lines and the scatter diagrams in Figure 3.

The net regression equation expressing these relationships was found to be

$$X_1^* = 2.92644 + .18341X_2 + .19672X_3 \\ - .00378X_4 - .00515X_5.^{12}$$

A clearer conception of the relative weights of the regression constants, how-

¹² These regression coefficients are expressed in terms of 100 X_1^* . This would necessitate their division by 100 if they are to be used in connection with the scatter-diagram units preceding.

ever, can be obtained from the expression involving the beta coefficients

$$Z_1 = .59004Z_2 + .05067Z_3 \\ - .03425Z_4 - .21259Z_5,$$

where $Z_1 \dots Z_5$ represent the variables expressed in standard error units and with origins at their respective arithmetic means.

In Table 4 the variance in the yield differentials is broken down to show the effect that each of the factors exerted upon it directly and indirectly in combination with each of the other variables.

From Table 4 it can readily be seen

TABLE 3

RELATIVE YIELD DIFFERENTIALS, WEIGHTED AVERAGE SURTAX RATES, AMOUNTS OF STATE AND LOCAL SECURITIES OUTSTANDING, INDEX OF COMMON-STOCK PRICES, AND CORPORATE NEW CAPITAL FLOTATIONS, 1919-41

Year	Relative Yield Differ- entials (Per Cent)	Weighted Average Sur- tax Rates (Per Cent)	Amounts of State and Local Securi- ties Out- standing (Billions of Dollars)	Index Com- mon-Stock Prices (1935-39= 100)	Corporate New Capital Flotations (Thousands of Dollars)
1919.....	1.27	47.3	7.04	74.6	187,199
1920.....	1.30	43.1	7.75	67.8	213,612
1921.....	1.24	42.0	8.48	58.3	141,812
1922.....	1.24	38.5	9.89	71.5	184,568
1923.....	1.25	37.6	10.60	72.9	219,615
1924.....	1.25	34.9	11.63	76.9	252,420
1925.....	1.22	19.1	12.83	94.8	300,375
1926.....	1.19	19.2	13.66	105.6	312,829
1927.....	1.16	19.2	14.74	124.9	388,067
1928.....	1.15	18.1	15.70	158.3	445,506
1929.....	1.14	18.3	16.76	200.9	666,839
1930.....	1.17	17.5	17.99	158.2	373,590
1931.....	1.21	19.1	19.06	99.5	129,221
1932.....	1.33	39.9	19.33	51.2	27,113
1933.....	1.26	40.1	19.52	67.0	13,382
1934.....	1.27	43.8	18.82	76.6	14,855
1935.....	1.28	44.2	18.97	82.9	33,631
1936.....	1.25	51.1	19.21	117.5	99,329
1937.....	1.25	50.7	19.15	117.5	102,084
1938.....	1.40	50.1	19.17	88.2	72,774
1939.....	1.44	49.6	19.63	94.2	31,954
1940.....	1.52	51.7	19.89	88.1	61,365
1941.....	1.75	56.3	19.86	80.0	86,443

Source: Yield differentials and tax rates computed; amounts outstanding from *Annual Reports of the United States Treasury*; common-stock indices from Cowles Commission and Standard and Poor's Corporation; new capital flotations from *Commercial and Financial Chronicle*.

that weighted tax rates were the most closely associated with the yield differentials. This factor alone accounted for 35 per cent of the 61 per cent of the total variance explained. In combination with other factors, it helped to account for another 10 per cent. New corporate capital flotations was the second most closely associated variable. Directly it accounted for 4.5 per cent and indirectly with other variables for 10 per cent of the variance in the yield differentials. The amounts of state and local securities outstanding directly explained only .26 per

cent, while stock prices directly accounted for only .12 per cent of the variance in the dependent variable.

The multiple coefficient of correlation was .78. Since a measure of correlation as large or larger than this would occur less than once in a hundred random samples from an uncorrelated universe, the multiple correlation coefficient is statistically significant on the 1 per cent level.

Other factors.—Even if we could assume that all future measurements would yield the same degree of correla-

FLUCTUATIONS IN DEPENDENT VARIABLE RELATIVE TO THOSE IN INDEPENDENT VARIABLES, 1919-1940

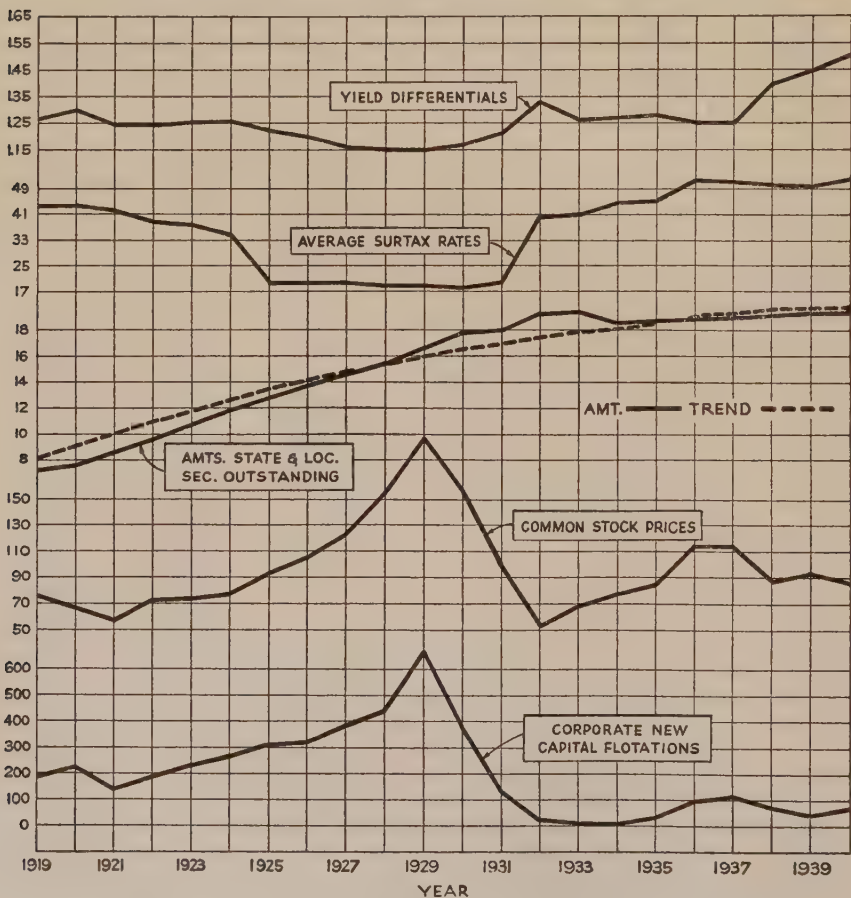


FIG. 2

RELATIONSHIPS BETWEEN THE RESIDUALS OF X'_1 AND X_2, X_3, X_4 , AND X_5

X'_1 = Square root of relative yield differentials (in per cent)

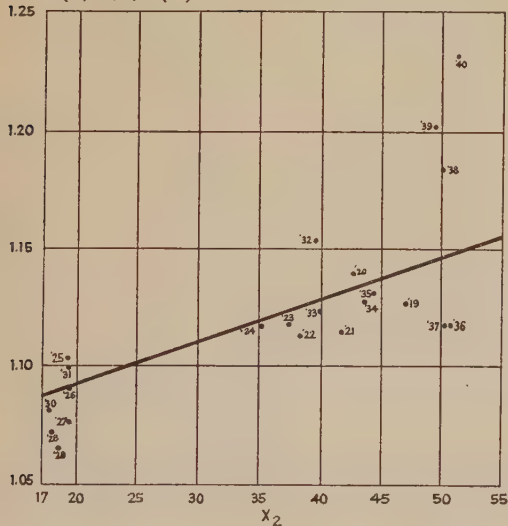
X_2 = Weighted average surtax rates (in per cent)

X_3 = Deviations from trend of amounts of state and local securities outstanding (in billions of dollars)

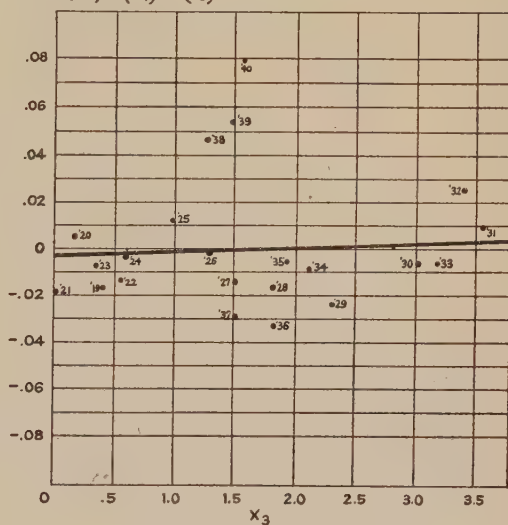
X_4 = Index of common-stock prices (1935-39 = 100)

X_5 = Corporate new capital flotations (in millions of dollars)

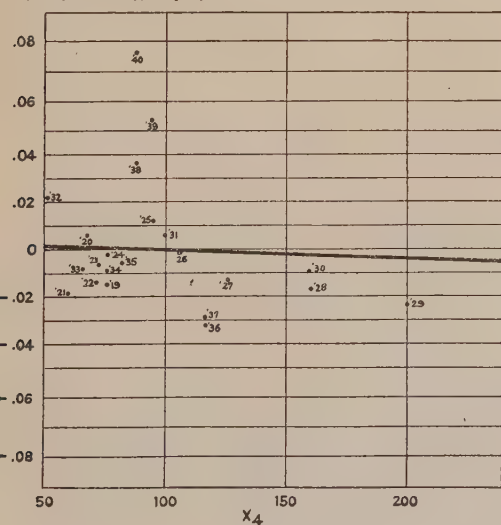
$$X'_1 - f(X_2) - f(X_4) - f(X_5)$$



$$X'_1 - f(X_2) - f(X_4) - f(X_5)$$



$$X'_1 - f(X_2) - f(X_3) - f(X_5)$$



$$X'_1 - f(X_2) - f(X_3) - f(X_4)$$

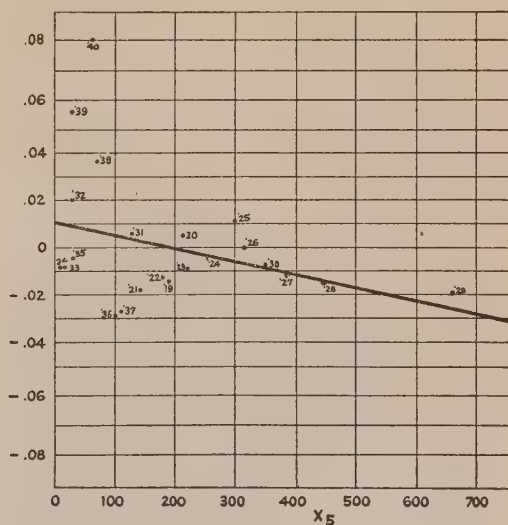


FIG. 3

tion as indicated by the present samples, the coefficient of multiple determination of .61 indicates that there still would remain at least 39 per cent of the variance in the yield differentials which is not associated with weighted surtax rates, exemptions outstanding, or alternative investments.

In this regard, the extreme deviations in the years 1938, 1939, and 1940 of the yield differentials from the regression lines are noted. It may be that the

plete and accurate information on the more vital portion for this problem—the distribution among the various income groups of individuals¹³—is lacking. Another factor which would well bear examination is that which must be called, for lack of more definitive language, “investors’ confidence.” Evidence of the existence or absence of this factor is probably seen in the cyclical shiftings taking place in security portfolios, but this factor in itself is too complex a phe-

TABLE 4
MAGNITUDES OF DIRECT AND INDIRECT INFLUENCES OF INDEPENDENT
VARIABLES ON σ^2 OF THE DEPENDENT VARIABLE

	PROPORTION σ^2 ASSOCIATED WITH:				TOTAL
	X_2	X_3	X_4	X_5	
Direct influence.....	.34817	.00257	.00117	.04519	.39710
Indirect influence					
X_2 and X_3	— .00809	— .00809			— .01618
X_2 and X_4	.01153		.01153		.02306
X_2 and X_5	.09673			.09673	.19346
X_3 and X_4		— .00053	— .00053		— .00106
X_3 and X_5		.00094		.00094	.00188
X_4 and X_5			.00562	.00562	.01124
R^2_{1-2345}					.60950

anticipated surtax rate levels for the higher bracket incomes were actually in excess of those imposed and thus helped to account for the spread occurring.

On the other hand, the recent pegging of the maximum capital gains tax at 25 per cent may have had the effect of reducing the spread by increasing the attractiveness of alternative investments.

There are many other forces and conditions which might be examined and which might account for the unexplained variance if the necessary measurements were available. Chief among these is the ownership of securities bearing exemptions. While data are extant on the institutional holdings of these bonds, com-

nomenon to be measured by any single statistical series.

In addition, there may be other factors which are affecting the sizes of these yield differentials and which may not be correlated with the size of the yield differentials attributable to tax exemption. A discussion of these factors is deferred, however, to the following section.

¹³ Some studies have been made of the investment items in estate tax returns which throw some light on this question. See reports of these studies in *Hearings before the Committee on Ways and Means* (77th Cong., 2d sess. [Washington: Government Printing Office, 1942]), III, 3087; and *Hearings before the Special (Senate) Committee on Taxation of Government Securities and Salaries* (76th Cong., 1st sess. [Washington, D.C.: Government Printing Office, 1939]), Part II, pp. 115-20, 172.

The absolute sizes of the premiums paid for whole tax exemption.—It is believed that one of the influences (and yet one which is very difficult to measure with any great degree of precision) affecting the sizes of the differentials obtained between the yields of the wholly exempt municipal bonds and the fully taxable corporate bonds was the psychological or real significance attributed to the relative risks involved in these two kinds of

these data, and Figure 4 is a graphic portrayal of this comparison.¹⁵

It is difficult to obtain a measure of this risk differential, since it varies with time and since the only period of data on which the estimates can be based is that of the duration of the second World War, when extraneous circumstances and non-normal situations might have exerted undue influences on the results. A rough estimate, however, would place the abso-

TABLE 5
YIELDS OF FEDERAL FULLY TAXABLE AND OF HIGH-GRADE CORPORATE BONDS
OCTOBER, 1941—DECEMBER, 1945

MONTH	YIELD									
	1941		1942		1943		1944		1945	
	Fed.	Corp.	Fed.	Corp.	Fed.	Corp.	Fed.	Corp.	Fed.	Corp.
January.....			2.48	2.83	2.46	2.79	2.49	2.72	2.44	2.69
February.....			2.48	2.85	2.46	2.77	2.49	2.74	2.38	2.65
March.....			2.46	2.86	2.48	2.76	2.48	2.74	2.40	2.62
April.....			2.44	2.83	2.48	2.76	2.48	2.74	2.39	2.61
May.....			2.45	2.85	2.46	2.74	2.49	2.73	2.39	2.62
June.....			2.43	2.85	2.45	2.72	2.49	2.73	2.35	2.61
July.....			2.46	2.83	2.45	2.69	2.49	2.72	2.34	2.60
August.....			2.47	2.81	2.46	2.69	2.48	2.71	2.36	2.61
September.....			2.46	2.80	2.48	2.69	2.47	2.72	2.37	2.62
October.....	2.34	2.73	2.45	2.80	2.48	2.70	2.48	2.72	2.35	2.62
November.....	2.34	2.72	2.47	2.79	2.48	2.71	2.48	2.72	2.33	2.62
December.....	2.47	2.80	2.49	2.81	2.49	2.74	2.48	2.70	2.33	2.61

Source: United States Treasury and Moody's Investors Service.

investments. While only bonds rated equally high by the agencies were used, this equivalence may have been due at times to a lack of more discriminating measurements or terminology rather than to a true risk equivalence.¹⁴ Some idea of the size of this risk differential may be obtained by comparing for the period for which data are available the average yields of fully taxable federal bonds against those of the high-grade corporate bond yields. Table 5 presents

lute risk differential anywhere from .24 to .39.¹⁶ Expressed in relatives, for the

¹⁵ For the corporate series, the yield indices computed for Aaa-rated bonds by Moody's Investors Service have been used. This substitution was necessitated by the fact that too many of the bonds used for the preceding analysis were approaching maturity too closely to make them longer representative in this more recent period. Except for depression periods the maximum difference between the index computed and used in this chapter and the Moody index was 0.08. Therefore, the discrepancy due to the substitution of indices is relatively small.

¹⁶ Earlier in the study it was planned to splice the corporate series into that span of the federal taxable series for which data were available. This plan, however, was abandoned. The reader can readily see the

¹⁴ For further discussion see Macaulay, *op. cit.*, pp. 58-60.

premiums which investors have been willing to pay to obtain whole exemption.

It is maintained, however, that the absolute yield differences do not so accurately state the situation as do the relative differences, since the magnitudes of the former are affected adversely by the yield level. It is believed that a better appreciation of the economic factors involved can be obtained from the statement that investors, in order to secure tax exemption, were willing to accept yields from 86 to 92 per cent as high as they might have received on high-grade corporates.

Federal wholly exempt bonds.—The yields of the federal fully exempt bonds which are at present outstanding have been employed by individuals seeking a measure of the premium paid for tax exemption. While it is understood that these persons resorted to this practice because of lack of more adequate data to fulfil their special needs, such a procedure is not advocated, owing to the unique nature of these bonds. At the present time the "Panamas" of 1961 with the "Conversions" of 1946 and 1947 are the only three bonds in this group. On June 30, 1945, there were only \$49,800,000 of the Panamas and \$15,761,000 of the 1946 and \$13,133,500 of the 1947 Conversions outstanding.¹⁸ This scarcity factor is coupled with the fact that the bonds bear a 3 per cent coupon rate and contain all the features of the most desirable securities with risk at a minimum. As would be expected, they are very inactive. While in the early twenties these

federal issues were being quoted as low as \$75, the Panamas in 1945 stood around \$135 and the Conversions around \$102–\$105. The yields on the Panamas are therefore around .70 and on the Conversions around .15 to .25. The Conversions are reflecting their closely approaching maturities. Over 98 per cent of these bonds are in private holdings, excluding those owned by banks and insurance companies.¹⁹

For these reasons it is felt that these bonds are not representative of the normal situation or that which is likely to occur. A complete analysis involving these yields has therefore been omitted from this study.

LOW-GRADE BONDS

Many fervent discussions have taken place which have pleaded the plight of the local unit and its dependence upon tax exemption in order to finance its operations.²⁰ However, these statements have been generally restricted to those of a "feeling gained through experience."

The attempt has been made here to approach this question by means of objective measurements. For this purpose eighteen bonds representing five cities were selected.²¹ These units were selected for the study, since they have so prominently figured in the discussions. They were also chosen on the advice and with the aid of staff members of one of the

¹⁹ Information furnished by Henry Murphy of the United States Treasury staff in his testimony in the Shamberg case.

²⁰ See particularly testimony of witnesses in the case of *Shamberg v. Commissioner of Internal Revenue*, Docket No. 107713 (1943), Tax Court of the United States.

²¹ Four of these bonds were issued by Asheville, and two by Buncombe, North Carolina; four by Clearwater, three by Coral Gables, and five by Tarpon Springs, Florida.

¹⁸ In addition, there were \$117,130,240 of the 2½ per cent Postal Savings bonds, but these cannot be classed with the three others in this group, owing to the fact that they are redeemable at any time at the option of the United States government or the holder. Including the Postal Savings bonds, the total of wholly exempt federal bonds outstanding on June 30, 1945, was therefore \$195,824,740 (see *Daily Treasury Statement*, July 2, 1945).

large municipal investment houses.²² The units selected maintained somewhat the same pattern of agency ratings, as can be seen from Table 6.

As will be noted from Table 6, there was for all the units a period in the early thirties, and for three of the cities a span in the latter thirties, when a total blackout of ratings occurred. This condition reflected the uncertainty of the financial position of these localities when

ties. They were perfectly mated as to coupon rates. For the bonds due to go off the market earliest, the maturities were held to no greater than one-year difference. For the longer maturities, the maximum difference was four years. The years for which information was available were held to no greater than one degree difference in rating between the municipal and its matched corporate bond.²³

TABLE 6
ANNUAL RATINGS ASSIGNED EACH OF THE FIVE LOCAL GOVERNMENT UNITS BY THE RATING AGENCY

YEAR	LOCAL UNIT					YEAR	LOCAL UNIT				
	A	B	C	D	E		A	B	C	D	E
1919.....	Aaa	Aaa				1931.....	†	†	†	†	†
1920.....	Aaa	Aaa				1932.....	†	†	†	†	†
1921.....	Aaa	Aaa				1933.....	†	†	Caa	†	Caa
1922.....	Aaa	Aaa			Aa	1934.....	Caa	†	Caa	Caa	Caa
1923.....	Aaa	Aaa	A		A	1935.....	Caa	†	Caa	Caa	Caa
1924.....	Aaa	Aaa	A		A	1936.....	Caa	Caa	Ca	Caa	†
1925.....	Aaa	Aaa	A		A	1937.....	B	B	†	†	†
1926.....	Aa	Aa	A		A	1938.....	Caa	Caa	†	†	†
1927.....	Aa	Aa	Baa	Baa	Baa	1939.....	Caa	Caa	†	†	†
1928.....	Aa	Aa	Baa	Baa	Baa	1940.....	Caa	Caa	†	†	†
1929.....	Aa	Aa	Baa	Ba	Baa	1941.....	Caa	†	†	†	†
1930.....	Aa	Aa	Ba	†	†						

Source: Moody's Investors Service.

† Absence of rating.

information was too incomplete and questionable to warrant classification.

However, owing to this condition and to the patterns of behavior of these municipal bonds, it was found difficult to match them to a high degree of comparability with corporate issues. Railroad bonds, on the whole, followed the trend closer than did those of utility or industrial organizations. With the exception of four utility bonds, the other city issues were matched with railroad securi-

Difficulty again was encountered when the attempt was made to secure prices for the municipals. Previous to the financial difficulties of these cities, their bonds were quoted only in terms of yields and, following that period, in prices. It was decided to convert the yields into prices and employ these in the analyses. This decision was reached in spite of the fact that it meant the sacrifice of direct

²² On the basis of the first criterion, Miami, Florida, should have been included, but its ratings by the agencies placed its securities on a little higher plane than those of the cities selected.

²³ It should be pointed out that a bond rated Caa compared to a B or even to a Ca probably does not represent the same degree of comparison as an Aa compared to an A. For further discussion on this subject see Gilbert Harold, *Bond Ratings as an Investment Guide* (New York: Ronald Press Co., 1938), esp. pp. 214, 219, and 226.

yield differential comparisons with the high-grade bond group. The very nature of the yield curve and the margin of error in the price measurements necessitated this procedure. Figure 5 illustrates the character of the yield curve. In constructing the curve, the low-maturity bond was selected in order to obtain the character of the maximum error. The asymptotic nature of the curve causes a very small increment in price to be re-

the municipal bonds fell below those of the corporates during this period. This phenomenon might be attributable to many causes. Since this period is the one embraced by the rating blackout, it could be that the bonds are not so perfectly matched during this span. The more valid explanation, however, seems to be the incidence of the financial crises for the two groups of bonds. While the municipals were in default by 1930 and

RELATIONSHIPS BETWEEN YIELDS AND PRICES FOR A 5½ % COUPON
RATE BOND WITH TEN YEARS TO MATURITY

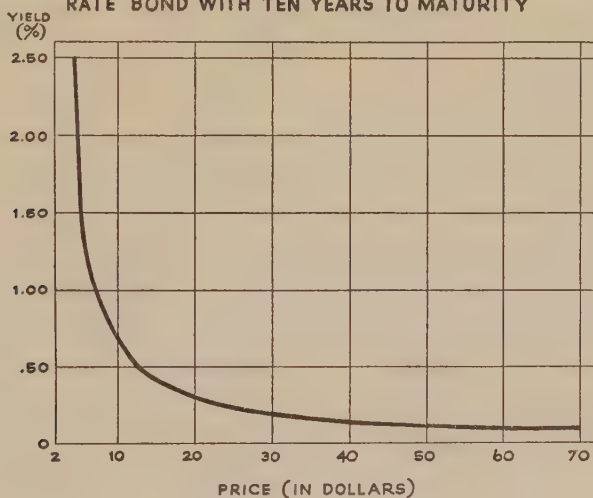


FIG. 5

sponsible for a very large rise in yield in the low-price ranges, the region where the low-grade bond prices fall. For instance, an erroneous price increase of \$1.00 could account for a 50 per cent change in yield in the lower ranges of prices.

Unweighted arithmetic annual averages were obtained from the monthly bid prices. The relative differentials between these price series can be seen in Figure 6.

While it can be seen that both series tumbled precipitously in the early thirties, the most striking feature of these curves is that the average bid prices for

1931, the corporates generally did not reach their depths of nonpayment until 1933 and 1934.

The different types of holders of these securities, the relative tangibility of their securing assets, and the relative breakdowns in moral fibers during this period of financial stress might also have influenced the picture. The fact that many of these municipal bonds were held by fraternal organizations where relatively high returns was a determining factor in investment but where tax exemption was not an important consideration against the holdings of the corpo-

rate bonds by different kinds of investors could have reasonably affected the shapes of these curves. Again, corporate bondholders lack the feeling of total loss due to the existence of tangible assets, one lacking for the municipal bondholders. Too, the delayed action of the municipalities in many instances was

corporate issue owners have had to accept common stock in exchange for their prior lien holdings.²⁴ These conditions are reflected in the curve spreads occurring after 1932.

Attention is also called to the fact that the corporate curve, particularly in the thirties, does not follow the general pat-

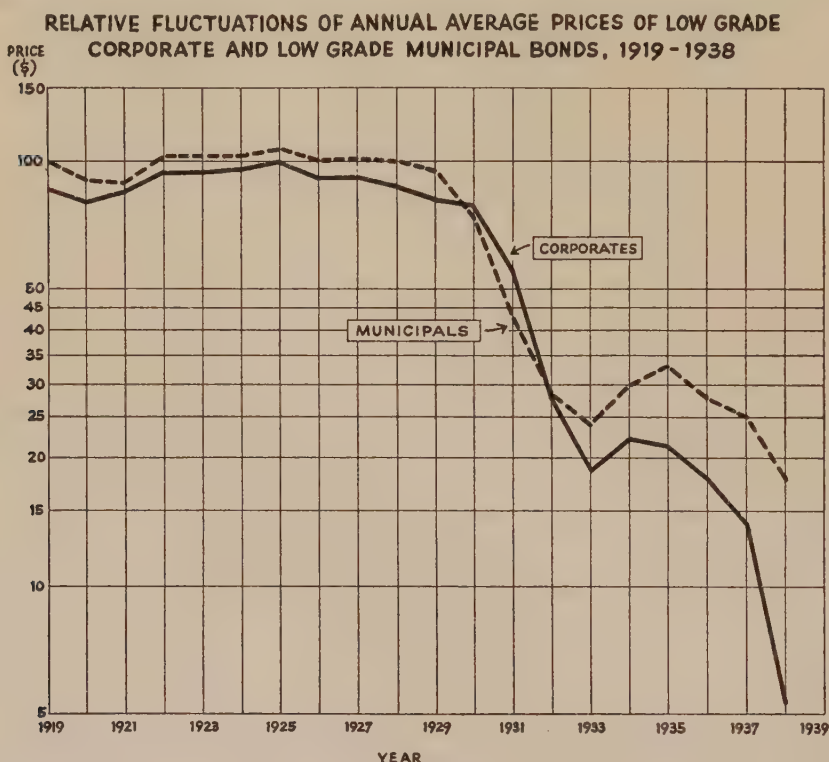


FIG. 6

not possible for the corporations, and the fixing of responsibilities from the viewpoint of investors was probably as direct for the corporate executives as it was scattered for the municipal officeholders.

However, following 1933 and 1934 the outlook for the municipal security owners has appeared somewhat the brighter of the two groups. Many municipal bond reorganization plans have been suggested and adopted, while in many instances the

tern of the Baa series of corporate issues.²⁵ This similarity would not necessarily be expected, however. The series here used represents a particular set of selected bonds which would not neces-

²⁴ In 1942 the property of one of these corporations was sold. In other cases the proceedings are still held in legal suits.

²⁵ This series represents that of the lowest rated bonds for which indices are computed by Moody's Investors Service. Standard and Poor's Corporation compiles a series for B-rated bonds, but below this class fall the C1+, C1, C, D1, and D groups.

sarily reflect the behavior of all members of that group. Again a Baa-rated bond is considered a "lower medium grade" of which "interest payments appear adequate for the present" and is really not in the class with a Caa-rated security which is "of poor standing" and which "may be in default" or "have elements of danger with respect to principal or interest." Of course, the spread of quality between the Baa and Ca ("obligations which are speculative in a high degree") or C (bonds "having extremely poor prospects of ever attaining any real investment standing") is even greater.

But what of tax exemption? It simply sums up to the fact that, where no interest is received on bonds, "tax exemption" for that income becomes just two dead words. In other periods, however, tax exemption does appear to be an added attraction to investors. While it would seem that the individuals falling in the highest income brackets, in which exemption would have the greatest value, would also be the conservative investors who would not consider such low grades as the types of municipals herein described, this is not altogether true. Owing to either or both of their daring spirits or pressures, they resort to speculative issues.²⁶ The differences between a fifty-cent return after taxes on a common stock against a two-dollars-and-fifty-cents tax-exempt return on a municipal can often determine the choice of the latter even if a high degree of uncertainty is involved.

The greater spread that occurred between the two curves in the period of the later twenties when surtax rates were low is believed due to other causes than tax exemption.

²⁶ The writer has been advised by investment counselors that as much as from 10 to 20 per cent of the assets of these individuals will sometimes be invested in securities of a speculative nature.

It can be stated that, for the low-grade issues studied, investors were willing to pay on the average during the period 1919 through 1941 about 10 per cent higher prices to obtain the issues bearing the tax-exemption feature. If the years 1930 and 1931 are excluded, this percentage difference rises to about 13 per cent. How much of this is directly attributable to tax exemption and how much to other factors it is impossible to say.

SUMMARY

In the period 1919 through 1940, investors have been willing to accept yields from 86 to 92 per cent as high as they might have received on high-grade corporate bonds in order to secure tax exemption. Surtax rates directly accounted for 35 per cent of the variance occurring in yield differentials. The other factors—corporate new capital flotations, amounts of state and local securities outstanding, and common-stock prices—ranked next in order in explaining the other 26 per cent of the yield differential variance which was associated with the factors tested. The remaining 39 per cent of the variance may have been due to types of ownership, "investors' confidence," or to the attitude toward the relative risks involved.

The risk factor was estimated to have accounted for .24 to .39 in the absolute sizes of the yield differences, which, after the adjustments for this factor and for the use of bid prices, varied from .35 to .65.

A complete analysis of federal wholly exempt bonds was omitted because of the unique nature of these securities.

The price curve for low-grade municipals remained above that for low-grade corporates except in the period of the early thirties. The inability to match the

bonds perfectly, the earlier defaults of the cities, the differences in the attitudes of investors toward the two kinds of bonds, particularly in periods of extreme financial difficulties, and the desire for tax exemption may have influenced the bondholders to pay from 10 to 13 per cent more to obtain the low-grade tax-exempt municipal over the low-grade fully taxable corporate bonds.

CHAPTER V

ANALYSIS OF YIELD DIFFERENTIALS: PARTIAL EXEMPTION FOR BOND INTEREST

IN THE previous chapter the problem of total tax exemption for interest was considered. This chapter will deal with that of partial exemption.¹ At the present it seems that the lapse of time will eradicate this problem entirely. Unless legal regulations are altered, partially tax-exempt securities will completely disappear from the market by December 15, 1965. This situation can exist as early as December 15, 1960, since the Treasury 2 $\frac{3}{4}$ per cent bonds bearing the 1965 maturity date are callable in 1960.² The peak in outstanding issues of the partially exempts was reached in 1941, with a total of slightly over \$36 billions. By June 30, 1945, only about \$22 billions of the total \$181 billions of United States marketable securities bore the partially exempt tax feature.

All the bonds of this type are issues of either the federal government or its agencies. Some of these obligations, therefore, are guaranteed by the United States, while others are not. The data for partially exempt bonds used in this chapter, however, represent only those securities which are direct issues and

guaranteed by the central government. The premiums which investors have been willing to pay to obtain total exemption over partial exemption and the factors affecting the sizes of these premiums will be considered first. A treatment of the problem of partial exemption compared to full taxation for security income will follow. Only high-grade bonds will be considered in this chapter, since only that type of security bears the partially tax-exempt feature.

PARTIALLY VERSUS WHOLLY EXEMPT BOND INCOME

The yield differentials (X_1).—Yields were chosen to reflect the investors' attitudes toward the securities used. To obtain a measure of the yields of bonds partially exempt, the series compiled by the federal Treasury was employed.³ In this series the Treasury has included from January 1, 1919, through October 14, 1925, all outstanding partially exempt government bonds with eight or more years to earliest call date and, from 1926, all partially exempt bonds outstanding with twelve or more years to earliest call date. During the period January 1, 1919, through October 14, 1925, certain Liberty Loan bonds were included, but after the latter date only Treasury bonds have been used. The annual average yields have been computed as unweighted arithmetic means of the monthly yields. The monthly yield aver-

¹ A partially exempt bond is free from federal normal taxes but subject to estate, inheritance, and gift taxes and to surtaxes. In some instances, however, the income from partially exempt bonds up to a principal amount of \$5,000 has been exempt from surtaxes. All these bonds are free from state and local levies.

² The federal Treasury series used in this study and giving yields of partially exempt bonds was discontinued December 15, 1945, in order to comply with the prevailing practice of including only bonds due or callable in fifteen or more years.

³ See Table 13 in the Appendix for a list of the bonds whose yields are included.

erages were means of the daily figures. Each daily figure was an unweighted average of the yields of the issues used based on the daily closing prices on the New York Stock Exchange, except that in some instances the mean of closing bid and ask prices was used. Yields of bonds selling above par and callable at par before maturity were computed on the basis of redemption at first call date, while for bonds selling below par yields were computed to maturity.

For the wholly exempt bond yield series, the one computed for municipal bonds and used in the preceding chapter was employed.⁴ The yields for this series are consistently lower than those computed for high-grade municipals by Standard and Poor's Corporation and by the *Bond Buyer*. This is probably a reflection of the very high-grade bonds used in the index computed.

While it is recognized that the coupon rates and maturity dates of the bonds in the municipal series are not so perfectly matched with those of the partially exempt securities as they were with those of the fully taxables of the preceding chapter, it is believed that the uncertainty aspects are probably more perfectly matched than between the municipals and corporates previously studied. Since these bonds do involve relatively small degrees of risk, their prices tend to fluctuate closer to par than would be true of lower-grade bonds. This fact tends to minimize the variations due to differences in coupon rates and maturities.

Percentage deviations were employed to measure the differentials of the federal partially exempt bond yields over the municipal wholly exempt bond yields. The two yield series are given in Table 7,

and their relative differentials are shown in Figure 7.

It can be noted from Table 7 and Figure 7 that the highest level of partially exempt bond yields was reached in 1920 and of wholly exempt yields in 1921.⁵ Since that time the trends for both series have been steadily downward—a reflection of the decline in the pure rate of interest. Cognizance of this fact has been taken, however, in the use of relative rather than absolute differentials in the yields. In spite of these trend conditions, the two series were relatively closest together in the middle thirties.

Similar factors to those chosen for study in the preceding chapter were selected for use in analyzing the yield differentials here derived. This selection was made for two primary reasons: judgment would lead one to believe that these would have the greatest influence and, by use of similar factors, comparisons might be made.

*The demand factor—level of surtax rates (X_2).—*The annual average weighted surtax rates computed to be used in explaining the variation between wholly exempt and fully taxable bond yields have been employed here. Since within a certain range the absolute differentials between partially and fully exempt bonds were negative, the "saving" due to the greater tax exemption actually showed a loss. While other factors which may have been influencing these results will be discussed in a later section of this chapter, it can readily be seen that computations of weighted average tax rates which are a function of the absolute differentials become meaningless in a situation of this type. Logically, one would come to the

⁴ See above, pp. 38-40, for a description of the bonds used and the computations made.

⁵ The maximum value for this yield series, 4.70, compares with 5.09 computed by Standard and Poor's Corporation and 5.02 by the *Bond Buyer*. For the period under study, these latter two also reached their peaks in 1921.

conclusion, however, that the level of the surtax bracket and of income for any given investor would be directly correlated with the size of premium he would pay for tax exemption. Even if the weighted average rates were based on a dipping into the lower surtax brackets, it

seems justifiable to assume that the relative sizes of the resultant values would not be greatly altered.

The supply factor—amounts of tax-exempt securities outstanding (X_3).—In order to obtain a measure which would reflect the relative scarcities of wholly

TABLE 7
AVERAGE ANNUAL YIELDS OF PARTIALLY EXEMPT FEDERAL BONDS AND
OF WHOLLY EXEMPT STATE AND MUNICIPAL BONDS, 1919-41

YEAR	BOND YIELD		YEAR	BOND YIELD	
	Partially Exempt	Wholly Exempt		Partially Exempt	Wholly Exempt
1919.....	4.73	4.20	1931.....	3.34	3.72
1920.....	5.32	4.54	1932.....	3.68	3.96
1921.....	5.09	4.70	1933.....	3.31	3.69
1922.....	4.30	4.09	1934.....	3.12	3.20
1923.....	4.36	4.05	1935.....	2.79	2.73
1924.....	4.06	4.00	1936.....	2.65	2.57
1925.....			1937.....	2.68	2.62
1926.....	3.86	3.97	1938.....	2.56	2.29
1927.....	3.68	3.98	1939.....	2.36	2.06
1928.....	3.34	3.91	1940.....	2.21	1.90
1929.....	3.33	3.92	1941.....	1.95	1.61
1930.....	3.60	4.20			
1931.....	3.29	3.97			

RELATIVE FLUCTUATIONS OF YIELDS OF PARTIALLY AND
WHOLLY EXEMPT BONDS 1919-1941

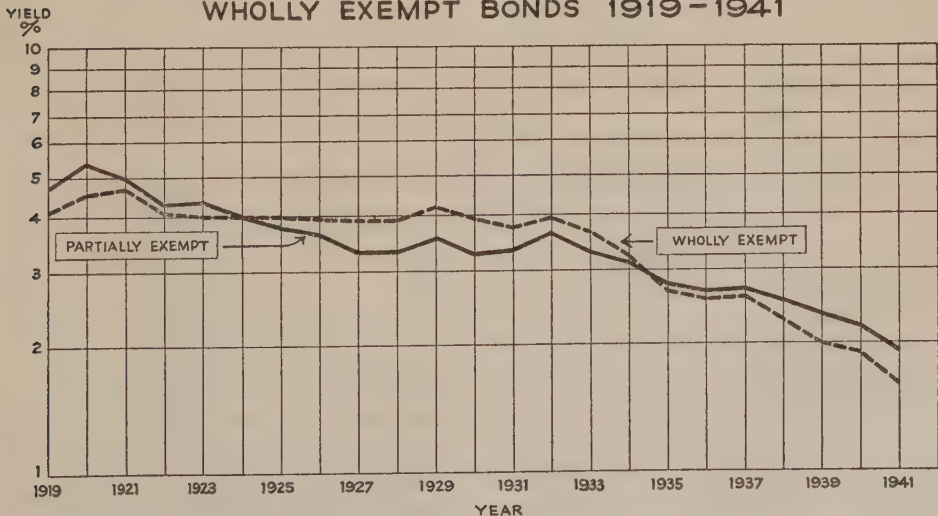


FIG. 7

exempt compared to partially exempt bonds outstanding, ratios of the former to the latter on each June 30 for the period 1919 through 1941 were obtained. This series of ratios reached a peak in 1933, owing to the fact that the wholly exempts climbed to a high not exceeded except in 1939 and years following, while the partially exempts were at a relatively low point in 1933. Following that year, however, the rate of increase of partially exempts has been so much greater than that of the wholly exempt municipals⁶ that the derived ratios consistently dropped. However, the trend curve with a positive slope, $Y_6 = 76 + 1.5X$, was fitted to these data in order to obtain the short-run fluctuations. A curve of this nature was used, since partially exempts must decline relatively while municipals outstanding are likely to increase,⁷ thus causing the ratios of wholly to partially exempts to rise.

*Alternative investment factors—stock prices (X_4) and amounts of state and local new capital issues (X_5).—*Preliminary analyses tended to indicate little if any association between common-stock prices and the yield differentials. On the assumption that those individuals who would select federal or very high-grade municipal bonds as a medium of investment would be likely to turn to preferred rather than to common stocks, the prices of the former were also tested as a possible influencing factor. It seemed from the preliminary examination that this assumption might be warranted.

The amounts of state and local new

capital issues as a determining factor were also tested. These introductory analyses, however, indicated practically no association with the other variables under study. Since the amounts of these new capital issues also represented the annual increment to the amounts outstanding and therefore a function of the supply factor used, this variable was dropped from further consideration.

Relationships among the factors.—The four sets of data, the relationships among which were further tested, are presented in Table 8 and as time series curves in Figure 8.

Unlike the relationships existing between the selected factors and the full exemption differentials, those for partial exemption appeared linear on all preliminary tests. This may be due to the fact that the returns for partial exemption are relatively smaller and to the fact that other economic circumstances tend to offset the expected ones. The hypothesis

$$X_{1c} = a + b_{12.34}X_2 + b_{13.24}X_3 + b_{14.23}X_4$$

was therefore chosen to express the net relationships. A graphic portrayal of the associations between the dependent factor or its residuals and the various independent factors is shown by the scatter diagrams and their regression lines in Figure 9.

The algebraic expression of the net relationships is contained in the equation

$$X_{1c} = .149177 + .005105X_2 \\ - .001503X_3 - .000011X_4,$$

where $X_1 \dots X_4$ are expressed in the same units as indicated in the scatter diagrams. It will be noted from both the geometric and the algebraic expressions of these relationships that, as the surtax rates have risen, the premiums paid for

⁶ These results are a reflection of the federal against the state and local financing policies following the depths of the depression of the thirties.

⁷ It has been estimated by municipal bond experts that six to eight billions of dollars of local issues are likely to be floated during the next five years. These estimates depend upon the availability of materials for public projects.

total relative to partial exemption have risen also. During the period 1919-41 a given rise of 10 per cent in the weighted surtax rates was accompanied on the average by an increase of 0.05 of 1 per cent in the relative amount paid for total

prices is negative, it is too small to be significant. Preferred-stock prices would have to have risen \$100 per share on the average to have affected the yield differentials even .0011 of 1 per cent. It is interesting to note that preferred-stock

TABLE 8
RELATIVE YIELD DIFFERENTIALS, WEIGHTED AVERAGE SURTAX RATES,
RATIO OF AMOUNTS OF STATE AND LOCAL TO FEDERAL PARTIALLY
EXEMPT SECURITIES OUTSTANDING, AND PREFERRED-STOCK PRICES,
1919-41

Year	Yield Differential	Weighted Average Tax Rate	Ratio Wholly to Partially Exempts Outstanding	Average Preferred-Stock Prices (\$ per Share)
1919.....	1.13	47.3	31.2	110.9
1920.....	1.17	43.1	37.0	103.2
1921.....	1.08	42.0	40.8	103.0
1922.....	1.05	38.5	48.4	114.0
1923.....	1.08	37.6	53.8	114.4
1924.....	1.02	34.9	62.2	115.2
1925.....	0.97	19.1	71.5	118.6
1926.....	0.92	19.2	80.3	121.0
1927.....	0.85	19.2	93.7	127.1
1928.....	0.85	18.1	106.9	136.7
1929.....	0.86	18.3	120.9	138.3
1930.....	0.83	17.5	155.5	140.2
1931.....	0.90	19.1	161.4	139.4
1932.....	0.93	39.9	160.2	114.7
1933.....	0.90	40.1	162.3	122.1
1934.....	0.98	43.8	132.2	132.5
1935.....	1.02	44.2	135.6	151.4
1936.....	1.03	51.1	109.9	161.9
1937.....	1.02	50.7	92.3	157.6
1938.....	1.12	50.1	83.0	161.4
1939.....	1.15	49.6	72.5	167.5
1940.....	1.16	51.7	67.5	169.2
1941.....	1.21	56.3	65.9	171.9

Source: Yield differentials and tax rates computed; securities outstanding from *Annual Reports of the United States Treasury*; preferred-stock prices from Standard and Poor's Corporation.

over partial exemption. On the other hand, as the relative amounts of wholly exempts to partially exempts outstanding tended to increase, the relative premiums paid for whole as against partial exemption fell. As the former increased 10 per cent, the latter tended on the average to decline .015 per cent. Although the relationship existing between the yield differentials and preferred-stock

prices seemed to be negatively correlated with the yield differentials during the first half of the period studied and positively correlated during the latter half.

The relative influences of the independent factors are more clearly indicated by the equation

$$Z_1 = .5927Z_2 - .50703Z_3 - .00211Z_4$$

and by the breakdown of the variance of X_1 shown in Table 9.

The multiple coefficient of determination of .88 thus gives a coefficient of correlation of .94. Since a measure of correlation as large or larger than this would occur less than once in a hundred random samples from an uncorrelated universe,

wholly to partially exempts outstanding. These two factors indirectly also accounted for another 28 per cent of the total variance. Preferred-stock prices in combination with surtax rates accounted for .01 per cent of the variance, but the

FLUCTUATIONS IN DEPENDENT VARIABLE RELATIVE TO THOSE IN INDEPENDENT VARIABLES, 1919 - 1941

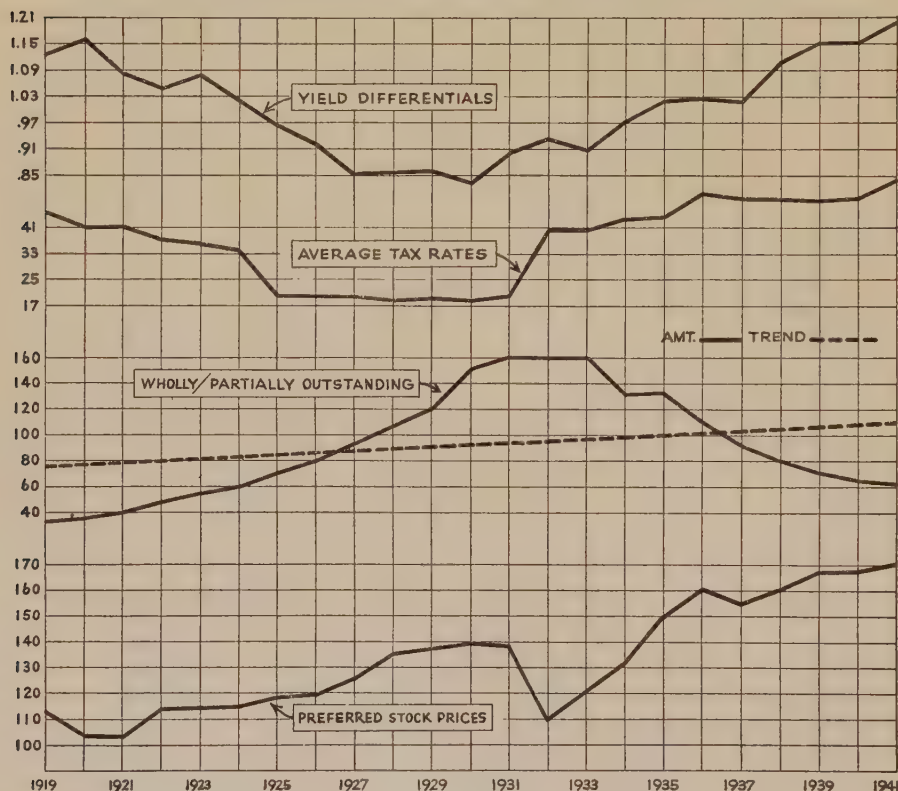


FIG. 8

the multiple correlation coefficient is statistically significant on the 1 per cent level.

Of the 88 per cent of the total variance in the yield differentials associated with the independent factors used, the greatest proportion—35 per cent—was directly attributable to the level of tax rates, and another 26 per cent was directly associated with the relative amounts of

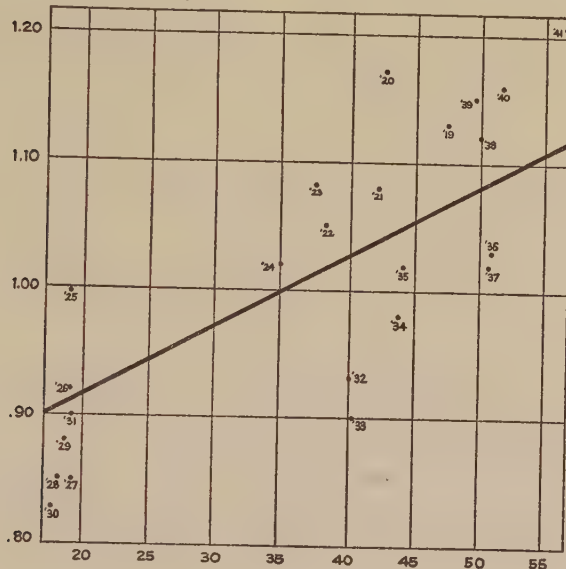
influence of preferred-stock prices alone was negligible.

Other factors.—The fact that, during the period 1925 through 1934, the curve representing yields of partially exempt bonds fell below that of the wholly exempt municipals indicates that forces having greater influences than tax exemption were present. It was during this period that the federal government was

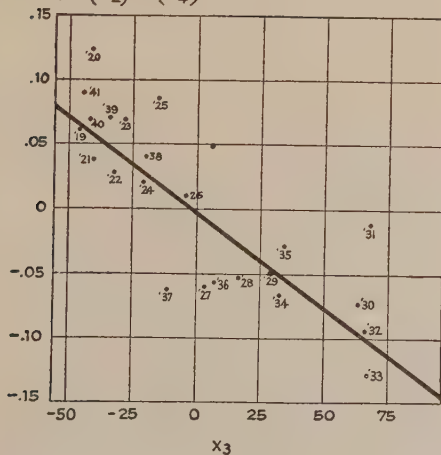
RELATIONSHIPS BETWEEN THE RESIDUALS OF X_1 AND X_2 , X_3 AND X_4

- X_1 = Relative yield differentials (in per cent)
 X_2 = Weighted average surtax rates (in per cent)
 X_3 = Deviations from trend of ratio of wholly exempt state and local to partially exempt federal securities outstanding
 X_4 = Preferred-stock prices (in dollars per share)

$$X_1 - f(X_3) - f(X_4)$$



$$X_1 - f(X_2) - f(X_4)$$



$$X_2$$

$$X_1 - f(X_2) - f(X_3)$$

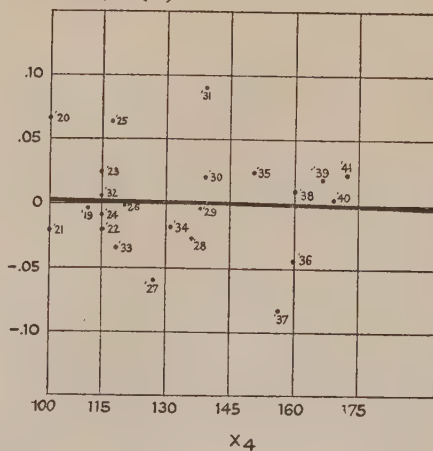


FIG. 9

retiring its debt, thus limiting the supply of the partially exempts. On the other hand, the banks with their high levels of deposits probably increased the demand for the decreasing supply. At the same time the supply of municipals was continually increasing. Some of these effects were reflected in the size of the negative correlation constants representing the outstandings ratios. These same circumstances were also evident in the fact that 95 per cent of the partially exempts, against 89 per cent of the municipals, on

assumption that conditions were not sufficiently representative to reflect normality, then it can be stated that investors were willing to accept yields on wholly exempt municipals which were only 95 per cent the size of the yields that they might have received on partially exempt federals.

On the other hand, if it be assumed that conditions prevailing in the last half of the twenties and the first half of the thirties were normal and to be expected in the future, then it must be concluded

TABLE 9
MAGNITUDES OF DIRECT AND INDIRECT INFLUENCES OF INDEPENDENT
VARIABLES ON σ^2 OF THE DEPENDENT VARIABLE

	PROPORTION σ^2 ASSOCIATED WITH:			TOTAL
	X_2	X_3	X_4	
Direct influence.....	.35132	.25708	.00000	.60840
Indirect influence				
X_2 and X_3	.13763	.13763		.27526
X_2 and X_4	.00005		.00005	.00010
X_3 and X_4		— .00000	— .00000	— .00000
R^2_{1-234}				.88376

the average, during this period were privately held.⁸ While the percentages of total partially exempt bonds held privately increased during the latter twenties and declined during the first half of the thirties, the percentages of total municipal securities in nongovernmental portfolios remained about constant during the latter twenties but increased in the thirties.

The effects of tax exemption.—If the last half of the twenties and the first half of the thirties are excluded on the

that, while there are periods in which whole tax exemption over partial exemption is a sufficient incentive to induce investors to accept lower yields, over the long period these differences cancel out completely, and the attractiveness of the two bonds as mediums of investments is on a par.

It is believed that a situation much more closely related to the latter is likely to exist for these bonds from now until their complete retirement in 1960 or 1965.⁹ However, it will not exactly

⁸ Private holdings include all securities in the portfolios of nongovernmental owners. This would include some institutional holders who come under special tax provisions and for whom exemption from the normal tax is the important consideration.

⁹ From November, 1941, through June, 1945, \$8.1 billions of these bonds were retired. Of these partially exempts retired, insurance companies furnished 55 per cent of the net total. Commercial banks, on the other hand, slightly increased their holdings during this period.

parallel that situation, since the level of surtax rates is likely to be higher and the scarcity element even greater. The limited supply factor, however, can be offset in part by the fully taxables of the federal government which will be outstanding. Shifts in portfolios will take place where increased interest rates are a factor. That these shifts are taking

upon the level of surtax rates, which will tend to spread them.

PARTIALLY EXEMPT AND FULLY TAXABLE BOND YIELDS

It is of interest to compare the relative sizes of the yields on the partially exempt with those on the fully taxable federal bonds in spite of the fact that the time

RELATIVE FLUCTUATIONS OF THE AVERAGE YIELDS OF FEDERAL PARTIALLY EXEMPT AND FULLY TAXABLE BONDS OCTOBER 1941 – NOVEMBER 1945

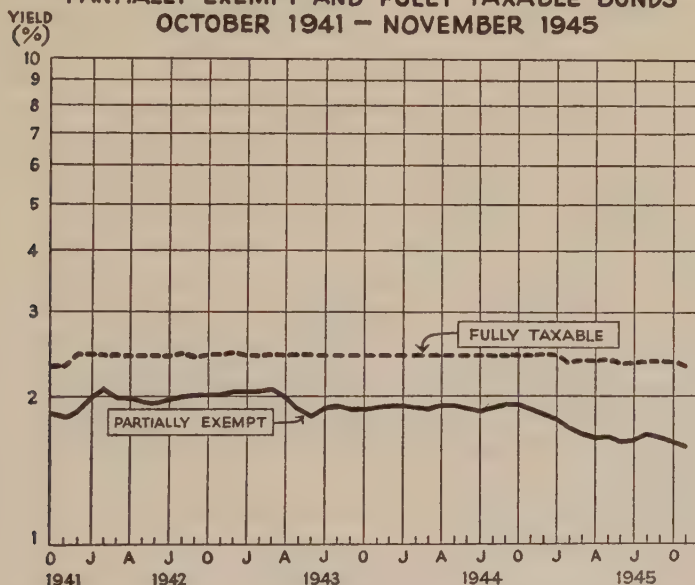


FIG. 10

place is evident from the fact that all investors decreased their holdings of federal exempts 8.1 per cent from November, 1941, through June, 1945. Of this 8.1 per cent, insurance companies furnished 4.4 per cent.

The other offsetting factor, the expected relatively high level of income-tax rates, will tend to throw its weight in favor of the wholly exempt municipal holdings. Therefore, the net result will depend upon the relative forces of the scarcity of outstandings, which will tend to narrow the yield differentials, and

period for which these data are available reflects the conditions of a war economy and the increasing supply of the latter against the diminishing supply of the former. These two series are shown in Figure 10.

The relative scarcity factor coupled with the desire for tax exemption probably accounted for the fact that the yields on the partially exempt securities were on the average only 78 per cent as large as those of the taxable bonds.¹⁰ The

¹⁰ Treasury officials have estimated the absolute size of the yield differential due to partial exemption

minimum relative difference occurred in February, 1942, when the partials' were only 15 per cent under the taxables' yields. The maximum spread occurred, as might be expected, in November, 1945, when the partials were 33 per cent under the yields of the bonds with taxed interest. Unless present conditions are altered, this spread is likely to continue in the future.

SUMMARY

In the periods 1919-25 and 1935-41, wholly exempt municipal bonds were more attractive to investors than were the partially exempt federal issues, but from 1925 to 1935 the reverse situation was true. During the former periods investors accepted on the average yields on their wholly exempt municipal bonds of 95 per cent the size of the partially exempt security yields. When the span of

the entire twenty-three years is considered, the relative desires for fully exempt municipal and for partially exempt federal bonds offset each other.

Surtax rates were the most influential in explaining the variance occurring in the relative sizes of the yields. The ratio of wholly to partially exempts outstanding came second in influence. These two factors alone directly accounted for 61 per cent of the 88 per cent of the total variance explained.

On the average, during the period October, 1941, through November, 1945, investors accepted on partially exempt securities yields which were 78 per cent as high as yields obtaining on the fully taxable federal bonds.

The magnitudes of yield spreads for the future will depend upon the relative intensities of the forces exerted by the level of income-tax rates, the scarcities of supply, and the willingness of investors to substitute fully taxables in order to obtain increased interest rates.

to be from .05 to .15 per cent (see *Hearings before the Committee on Ways and Means* [76th Cong., 1st sess. (Washington, D.C.: Government Printing Office, 1939)], p. 46).

CHAPTER VI

ANALYSIS OF YIELD DIFFERENTIALS: CORPORATE BOND TAX-FREE CLAUSES

THERE are two types of exemptions from income taxes which investors may obtain through the holding of corporate issues bearing tax-free provisions. One of these, the tax-free covenant, provides that the issuer pay the tax directly for the bondholder. The other type, that of the tax-refund clause, stipulates that the recipient of the bond interest receives from the corporation a certain refund on the income tax which he pays directly.

Most of the clauses limit the federal tax payment to 2 per cent. This stems from the fact that previous to 1918 the normal tax did not exceed 2 per cent. In that year the practice of collecting the income taxes directly from the bondholder rather than the issuer was adopted. A provision was made in the law, however, that if a borrower promised to pay interest without deduction for federal income taxes which that borrower might be required to pay or retain, then he would withhold the federal income tax in amount of 2 per cent. Without this withholding provision, which continues in effect with respect to bonds issued prior to January 1, 1934, tax-free covenants would be inoperative. Holders of tax-free covenant bonds issued on or after January 1, 1934, are required to account for the full federal income tax on their interest. Investing corporations, however, do not benefit by these covenants, since issuers are not required to withhold federal income taxes on interest paid to them.

If the securities were floated after January 1, 1934, issuers cannot pay income taxes on their bond interest directly, but they may agree by means of the refund clauses to reimburse the holder up to 2 per cent or any other amount. The 2 per cent is the most commonly occurring promise. Refunding, however, is not possible on bonds issued prior to January 1, 1934, as the tax payments on that interest must be withheld even if the bonds contain provision for refunds to the holders.

In addition to these clauses covering payment of portions of the federal income taxes, bonds also sometimes contain promises to cover one or more types of state taxes. Chief among these is the Pennsylvania four-mills tax.¹

These special tax-free clauses, however, do not appear now with as great a frequency in bonds outstanding as was formerly the case. For instance, in 1945 there were only 131 railroad issues listed which carried any type of provision for state or state and federal tax payments or refunds. Of these 131, 126 contained clauses concerning the Pennsylvania taxes, 4 of the same bonds listed Connecticut, and 1 of the same group Massachusetts, exemption provisions.

In order to measure the value investors might attach to these tax-free clauses, bonds were matched as far as possible except for the absence or pres-

¹ These taxes really embrace two types: the corporate loans tax and the county personal property tax.

ence of these special provisions. The fact that the price paid for this exemption, if it could be segregated, would probably be very small, necessitated the closest possible matching of the bonds selected in order to hold constant other variables which might also affect the price differences. For this purpose five sets of bonds were located.² Each set of bonds was issued by the same corporation and bore identical coupon rate and maturity date but varied in that one had a tax-free clause while the one with which it was matched did not. Four of these bonds carried the 2 per cent federal exemption, while their mates made no promises to pay any income tax. One bond made provision for covering the Pennsylvania four-mills tax and the federal 2 per cent, while its mate agreed to pay only the 2 per cent federal tax. In two sets the bonds were of the same series, the one differing from the other in that it was a "stamped" bond. The stamp in one case provided for "nonpayment of federal income tax" and in the second case the bond was "stamped as to Pennsylvania tax."³

The average prices for the five tax-free clause bonds and for the five bonds without these special provisions are given in Table 10.

The prices of the bonds bearing the exemptions fell below those without this feature in about as many years as they rose above. In fact, the average of the price differences in the positive direction

exactly equaled the average of the price differences in the negative direction. Figure 11 shows these price divergences. The price differences for years in which the average price of the tax-free clause bonds exceeded that of the plain bonds are shown above the zero base line, while those for years in which the plain bond price was higher appear below the zero line.

While there seems to be no relationship between the pattern of these price differences and the level of income-tax rates, it is interesting to note that the maximum difference in favor of the plain bonds occurred in the depression years. Many factors, such as relative demand and supply as well as intensity of trading—almost independent of the tax-exemption feature—could have accounted for these fluctuations.

A further attempt was made to measure the price premiums for the exemption by comparing only the two sets of stamped bonds. These two price series are shown on Table 11.

In some years the plain bonds were priced higher, on the average, but the average prices of the securities bearing the tax-exemption provisions were higher than those without this special feature in fourteen of the twenty-three years. The tax-exempts maintained, on the average, prices which were twenty-two cents higher than the prices of the other group. Therefore, it can be stated that if the small price differential for the tax-free clauses is an incentive to bond purchasers, it does not amount to more than 22 cents, or .22 per cent of the price of a \$100 bond.

The graphic portrayal of the absolute differences for the two sets of stamped bonds is shown in Figure 12. Price divergences in favor of tax-free clause bonds appear above the zero base line;

² There was a sixth set which appeared as perfectly matched as those chosen but which could not be used, since their quotations were stated in yields to the nearest .05 per cent only.

³ On the latter bond the New York Stock Exchange ruled in 1932 that a transaction in bonds of this issue without any special designation might be settled by delivery of either plain or stamped bonds, but, where the transactions were in stamped bonds, only bonds bearing the printed legend would be a delivery.

TABLE 10
AVERAGE ANNUAL PRICES OF TAX-FREE CLAUSE BONDS AND
OF PLAIN BONDS, 1919-41

YEAR	AVERAGE ANNUAL PRICE		YEAR	AVERAGE ANNUAL PRICE	
	Tax-Free Clause Bonds	Plain Bonds		Tax-Free Clause Bonds	Plain Bonds
1919.....	\$76.44	\$76.76	1931.....	\$88.25	\$89.27
1920.....	70.14	70.52	1932.....	65.59	66.12
1921.....	72.86	72.45	1933.....	67.24	68.91
1922.....	82.22	81.82	1934.....	79.35	80.09
1923.....	80.14	80.78	1935.....	73.80	73.37
1924.....	80.73	81.35	1936.....	80.12	79.38
1925.....	86.32	86.41	1937.....	75.31	74.71
1926.....	89.16	89.46	1938.....	57.02	57.05
1927.....	93.58	93.50	1939.....	57.41	57.46
1928.....	94.97	94.25	1940.....	46.41	45.37
1929.....	89.91	89.80	1941.....	52.49	51.62
1930.....	92.30	92.04			

ABSOLUTE SIZES OF EXCESS OF AVERAGE PRICES OF FIVE TAX-FREE CLAUSE BONDS
OVER AVERAGE PRICES OF FIVE MATCHED PLAIN BONDS, 1919 - 1941



FIG. 11

TABLE 11
AVERAGE ANNUAL PRICES OF TAX-FREE CLAUSE BONDS AND
OF PLAIN BONDS, 1919-41
(Stamped Bonds)

YEAR	AVERAGE ANNUAL PRICE		YEAR	AVERAGE ANNUAL PRICE	
	Tax-Free Clause Bonds	Plain Bonds		Tax-Free Clause Bonds	Plain Bonds
1919.....	\$80.17	\$80.45	1931.....	\$91.72	\$92.66
1920.....	73.89	73.31	1932.....	70.74	69.54
1921.....	75.44	73.99	1933.....	71.45	71.92
1922.....	85.32	83.91	1934.....	79.62	80.38
1923.....	82.27	82.28	1935.....	73.40	72.79
1924.....	82.19	82.65	1936.....	74.78	74.07
1925.....	88.40	88.54	1937.....	71.78	70.61
1926.....	91.66	91.73	1938.....	61.11	60.86
1927.....	96.44	96.32	1939.....	59.76	59.62
1928.....	96.77	96.62	1940.....	14.11	14.07
1929.....	92.38	92.57	1941.....	23.02	22.93
1930.....	95.27	94.89			

ABSOLUTE SIZES OF EXCESS OF AVERAGE PRICES OF TWO BONDS BEARING TAX
EXEMPTION OVER AVERAGE PRICES OF TWO MATCHED PLAIN BONDS, 1919 - 1941
(STAMPED BONDS)

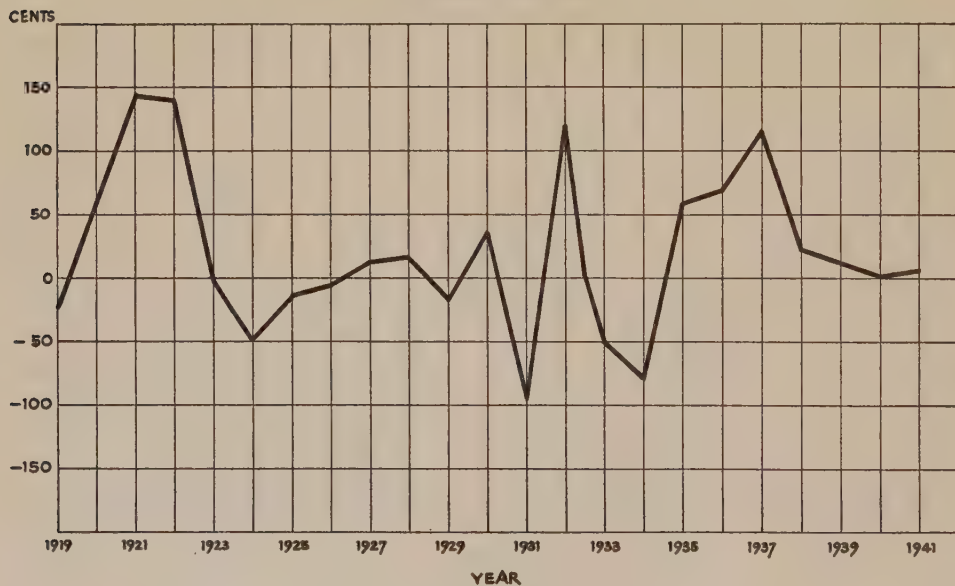


FIG. 12

those in favor of plain bonds, below the base line.

It can be noted from Figure 12 that, while the variations in prices were not so extreme for these two sets of bonds as for the five sets of Figure 11, the fluctuations maintained no consistent pattern. The fact that the curve crosses and recrosses the base line indicates that forces other than tax exemption were acting upon these prices. On the other hand, the fact that more often the prices are above the zero line tends to show that these bonds are probably more perfectly matched than were the five previously studied and that the tax-exemption feature is more nearly segregated.

SUMMARY

It may be stated that if the premiums paid for tax-free clause corporate bond exemption could be measured, it probably would not be over 22 cents on the average on a \$100 bond. The vagaries of

the market are so many and varied and the relative size of the exemption so small that it is difficult to state with any degree of certainty whether or not a factor of this kind has been measured with any great precision. The amounts outstanding, the relative frequency of trading, as well as the time of trading, whether or not the bond is registered,⁴ the types of owners—these, plus the relative degrees of uncertainties attributed to any given bond, all act and interact to affect its price. To state that any two bonds are exactly alike except for a tax-free clause is to oversimplify the problem.

Simply because it is difficult to measure the size of this exemption premium does not mean that it does not exist. It does mean, however, that it is easily dominated by many other attributes which a bond may bring to the market.

⁴ The writer has been advised by bond traders that the registered feature of a bond can affect its price in one direction on a sale and in the opposite direction on a purchase.

CHAPTER VII

EVALUATION

THE conclusions reached in the previous chapters have shown that investors in the period 1919 through 1940 were willing to accept yields on their very high-grade wholly tax-exempt bonds which varied from 86 to 92 per cent of the size of the yields which were obtaining during that period on an equal grade of fully taxable bonds,¹ and at no time did the yields of the taxed interest bonds fall to the level of those bearing the exemptions. Surtax rates appeared to be the most influential factor in determining the sizes of these premiums, while the amounts of tax-exempt securities outstanding was a close second in its importance. This latter variable became particularly significant when the scarcity element was present.

For very low-grade bonds, however, the picture was not the same. While during the more prosperous periods the prices of the municipals remained on the average from 10 to 13 per cent above those paid for the fully taxable bonds, the period of financial stringency completely wiped out the increment paid for the exemption.²

¹ It should be pointed out that this situation held only for the status quo. If some of the investors in wholly exempt bonds had bought the taxables, the relative prices might have shifted, thus affecting the yields and the yield differentials.

² The proportion of the total public debt represented by the low-grade issues varies with the status of the general economic conditions. Of the \$15.9 billions of local public debt rated in 1939 by Moody's Investors Service, \$11.6 millions, or 73.2 per cent, was qualified A, Aa, or Aaa. If Baa ratings were included, this percentage rose to 93.7 per cent. On the other hand, in 1934 forty-one of the forty-eight states had defaults within their borders. In 1938

It should be pointed out that the analyses which have been carried out were based on a period which is past. While the span studied contained one major prosperity period and one of the greatest of the depressions, the assumption that any set of elapsed interacting economic and social conditions would be completely duplicated in the future would be an oversimplification of the situation. However, it can be said that the probabilities of obtaining future results paralleling those preceding are greater in proportion as the relationships found existing in the past were of a casual nature. In so far as the reciprocal dependence found was due to the action of other forces through their simultaneous influences on the factors under study, the probabilities of finding them duplicated in the future decreases as these forces are multiplied. Again, in so far as the relationships were in any way due to purely spurious association, the chances for their repetition become problematical indeed.

The question now arises concerning the implications which these findings have for the issuer of the tax-exempt securities, for the investors in these bonds, for the taxpayer, and for the public in general. While these groups are not independent of one another, certain aspects of the problem are of relatively more vital interest to each. While the fiscal angles are considered primarily by

over three thousand governmental units were in default, and the defaulted bond total stood between \$1 and \$2.8 billions.

the issuers, the social and economic phases are rated important by the taxpayer and general public. The investor, representing either or all of these groups, becomes a partial determiner of the policies and at the same time a recipient of the benefits or losses resulting. The legal aspects, of course, overlap all the others.

For the present consideration, the issuers of the public securities fall into two large classes. First, there is the federal government and, second, the state, local, and territorial governments. Each of these groups is distinguished by the relative proportion of the total tax-exempt securities outstanding which it has issued, the relative degrees of exemption afforded the holders of its securities,³ the relative level of its tax rate structure⁴ as well as the average rates of interest it must pay to market its securities.⁵ Too, the federal exemption is imbedded in a contract, while that of the local units depends upon judicial interpretation and congressional action.

Investors in tax-exempt securities differ in degree, depending upon their relative taxable incomes, the types of

securities held, the incidence of the purchase of the bonds, and the subsequent shifts occurring in tax levies during the interval of ownership.

The chief fiscal consideration concerns the recouping, through price increments of tax exempts, the losses sustained through decreased tax collections (or the tax payments or refunds in the case of corporate tax-free clauses) and, in the absence of the exemptions, the level of interest rates necessary to attract the required investible funds.

There are two approaches to the first phase of this fiscal problem. A set of hypothetical conditions could be set up for each governmental group, and, with the variables held fixed, amounts of gains or losses involved in each case could be computed. As can readily be observed, the results from such a procedure would vary, depending upon the underlying assumptions. That such is the case is evident in the fact that estimates have been made which ranged from a loss to a gain of approximately \$200 millions when all issuers were considered.⁶ The second approach, which is more comprehensive in its scope, is to consider the major factors affecting the possible sizes of these revenues.

From the analyses of the preceding chapters, it was seen that the price-tax relationships for the issuers and investors would be functions of the tax rate structure, the character of income distribution, and the supply of tax exempts.

³ In 1944 the federal government had \$1,414 millions of wholly exempt and \$23,864 millions of partially exempt securities outstanding. In addition, its agencies had obligations of \$1,102 millions of wholly exempt bonds which were not guaranteed by the central government. In the same year the state, local, and territorial governments combined had \$15,965 millions of wholly exempt issues outstanding.

⁴ While the maximum surtax rates imposed by the federal government reached 91 per cent in 1944, a 15 per cent rate was high for state levies. The municipalities lacked this feature, since they do not impose income taxes.

⁵ The average rate of interest computed by the Treasury Department on the federal interest-bearing debt for 1939 was 2.6 per cent. During the same year the states were paying 4 per cent or higher on 62 per cent of their securities outstanding, and cities of 100,000 or over population were paying 4 per cent or higher on 73 per cent of their obligations.

⁶ For these estimates and for methods used in computing them see *Hearings before the Special (Senate) Committee on Taxation of Government Securities and Salaries* (76th Cong., 1st sess. [Washington: Government Printing Office, 1939]), pp. 10, 35, 93, 106-42; *Hearings before the Committee on Ways and Means* (76th Cong., 1st sess. [Washington: Government Printing Office, 1942]), I, 8; III, 3079; and *Hearings before the Committee on Finance* (78th Cong., 1st sess. [Washington: Government Printing Office, 1942]), I, 558.

Some of these relationships can be more clearly pointed out by the use of a geometrical diagram (Fig. 13).

As the supply shifts to the right (increases), the lower tax expectant investors become potential purchasers. Simultaneously, the price at which the securities are traded falls. The selling price is

tion of the area $DP''P$, and an equal amount is lost to the issuer.

It must be remembered that, since many of these securities not only bear the tax-exempt feature but are relatively freer of uncertainty elements than other securities, they are bid for by organizations and institutions to which,

STATIC RELATIONSHIPS AMONG LEVELS
OF TAX-RATE EXPECTATIONS AND
TAX-EXEMPT SECURITY DEMAND

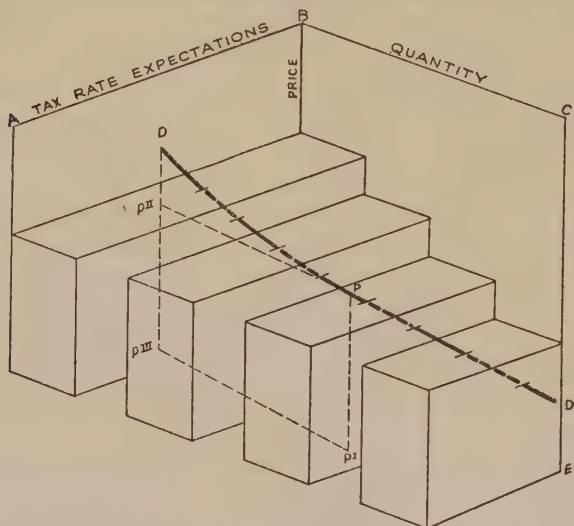


FIG. 13

Let AB represent tax-rate expectations,

BC the quantity of tax-exempt securities taken at any given price, and

CE the market price of the securities.

Let each large block represent the conditions of the group of investors falling in the level of taxable income which for them gives them those tax-rate expectations. (The number of groups is not meant to be exhaustive but merely illustrative. These potential taxpayers would vary in degree. The flat-top blocks are used for the sake of simplicity.)

Let DD' represent the demand for tax-exempt securities.

therefore fixed at that point where the marginal demand would be just sufficient to absorb the available supply. Suppose this situation occurred in the second block from the right. The price is represented by PP' and the total returns to the issuer by the parallelogram PP''' . But the total tax value is represented by $PP'P'''D$. The investors above the marginal purchaser therefore gain the amount represented by the integra-

because of legal regulations, the first attribute has little meaning but to which the second characteristic is very important. Since surtaxes are not applicable to some of these institutions, the price increments for that feature are completely lacking in their bidding.

In so far as the total tax payments remain fixed, the deficit due to taxable values falling to particular investors must be supplied by all taxpayers. To the

extent that this additional burden is distributed in proportion to the levies already imposed, those who experience the windfall gains through purchasing tax-exempt securities pay also in proportion to their taxable holdings. In so far as this deficit is supplied by low-bracket investors or noninvestors, the

tax-exempt market, are called and fully taxables replace them. State and municipal issues will then be the only bonds available whose interest is wholly exempt, and these will—at least in the relatively near future—represent a comparatively small proportion of all public issues.

DYNAMIC RELATIONSHIPS AMONG LEVELS OF
TAX-RATE EXPECTATIONS AND TAX-
EXEMPT SECURITY DEMAND

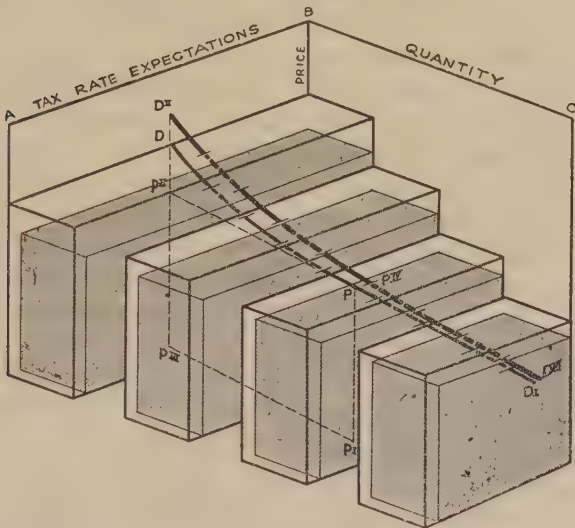


FIG. 14

Let the shaded portions represent the old levels of tax-rate expectations and demand for tax-exempt securities.

Let the heavy black lines represent the new levels of tax-rate expectations and demand for tax-exempt securities.

Notation used same as that shown on Figure 13 and explained in connection with that figure.

amount represents a subsidy from that group to the high-bracket investors.

If, however, the supply of tax-exempt securities should become so limited that they when issued are in demand by the highest surtax bracket group only, then the price paid would tend to offset completely the tax-exempt value. The trend will probably be in this direction as the securities of the federal government, which heretofore have dominated the

Where securities are issued in a period when surtax rate expectations place the levels high—and therefore prices are bid up—but are held through a period when the surtax rates fall, the issuer may gain while the investor is the loser. This situation will be demonstrated later.

The analyses discussed in connection with Figure 13 were based on a period in which the surtax rate levels remained fixed. The more realistic consideration,

however, is one of shift, and, following our past experiences (except for a period in the late twenties), a shift to successively higher income tax plateaus. The effects for the issuer and investor in a period of rising tax rates where expectations at the time of purchase did not anticipate these rises is illustrated by Figure 14.

While $PP'P''P'''$ still represents the value return to the issuer at the time of issuance, $P'P''D'P'''$ represents the total value at the existing higher level of tax rates. The difference between $DP'''P'P$ and $D'P''P'P'''$ or $D'DPP''$ represents the windfall gains to the investor if the expected rises in tax rates develop. These gains are in addition to those pointed out in Figure 13, which were due to the investor's falling in a higher surtax bracket than the marginal purchaser.

While other forces may be so dominant as to overshadow completely the consideration of the existing against future levels of tax rates in determining when issues are to be floated,⁷ that timing is a determiner of whether the price premiums will offset the tax losses. Expectations are based on short-run forecasts. Investors cannot and do not forecast far into the future. For instance, what persons purchasing the New York State 4's in 1910 ever even dreamed that before the bond matured in 1960 interest from that security would be exempt, while if he bought the Winston-Salem Southbound Railroad 4's in the same year, that before it matured in 1960, although he would be holding a security of approximately equal rating, he might also be paying three-fourths or more of his interest re-

ceived in income taxes? Forecasts of the future would be precarious enough even if the facts were available. But the appreciation on these bonds due to the fortuitous circumstances which did develop for the first one did not fall to the issuer but to the holder of the security, and the size of this appreciation is a function of the investor's estimate of the value to him of the tax exemption.

Where securities are issued in a downswing of the income-tax rate structure, the opposite effects will hold. If the reader will imagine the situation reversed on Figure 14 and the heavy black lines representing the original tax rate expectations and the shaded portions the developments, he will note the picture on the downswing of the tax rate structure when the investor may lose while the issuer gained relatively on the higher prices originally paid.

It is in these effects, due to the variabilities among bidders and in the dynamics of the situation, that inequities develop. So long as the prices are paid to the issuer at one point in time while the expectant tax offsets occur at another point in time, with all the economic forces at work in the meantime, their complete balance will be more a matter of random chance than the results of any planning, however astute.

With few exceptions, the higher surtax level investors have stood to gain through the purchase of tax-exempt securities. However, the propositions that "the wealthy *can* escape taxation" and that "the wealthy *do* escape taxation" are two different considerations. The preceding discussion would confirm previous analyses in establishing the first proposition. That this proposition holds is also demonstrated by the fact that in 1944 a holder of a 4 per cent wholly exempt bond, when such holder fell in as

⁷ Of course, the very floating of these securities by increasing the debt may necessitate the raising of tax rates.

low an income bracket as \$20,000, received the same gross annual yield on this security as he would have obtained on a fully taxable bond yielding 8.54 per cent. If it is assumed that this owner purchased the wholly exempt security in 1941 and paid the full premium for the exemption at that time, in 1944 his gain would approximate 1.65 per cent. If the security was purchased in 1935, his windfall would be 3.83 per cent; if in 1929, 4.14 per cent; and if as early as 1916, he would profit by the entire 8.54 per cent.

To what extent wealthy investors do take advantage of this opportunity is a debatable question. The information on this point is too inadequate to allow conclusions to be drawn.⁸ Some studies have been made of estate-tax returns which show that the percentages of the gross estates which were composed of state and local wholly exempt securities in 1934, a high year, ranged from 3.4 per cent for net estates of from \$100,000 to \$200,000 to 23.9 per cent for estates of \$1,100,000 and over. These holdings, however, fell in the period 1934-37. In 1938 the range was from 3.2 per cent in the lower estate group to 22.7 per cent in the higher one. By 1940 the holdings had again decreased. An analysis of the

income-tax reports of twenty-five persons, each of whom in 1937 reported net incomes in excess of one million dollars, revealed that these taxpayers reported receipts of almost seven million dollars of wholly exempt interest. This group of wealthy individuals had approximately one-third more net income than they would have received had they held securities yielding 15 per cent more taxable interest.⁹ On the other hand, a study made by Mr. Chatters pointed out that in 1938 only 18 per cent of the total amount of state and municipal securities outstanding was held by persons with net incomes in excess of \$15,000.¹⁰ In 1939 the Treasury cited one individual whose income tax was \$1,000,000 but who would have paid \$2,500,000 had he not held tax-exempt securities.¹¹ It can be stated that the fewer the wealthy holders of these bonds, the greater the gain for those who do invest in them, since they are free of the competitive bidding of others in their income classes.

With regard to the second phase of the fiscal problem—that of the effects on interest rates due to the withdrawal of exemptions—it is believed that the long-run effects have been exaggerated by those who have emphasized the adverse effects. In the short run, refunding operations or new issues might call for relatively higher levels of interest rates if prices were to be maintained. However, in the long run, in so far as these increases tended to raise the general level of interest rates, the relative disadvantages would disappear.

⁹ Study made by the United States Treasury Department.

¹⁰ Carl H. Chatters, "Distribution of Tax-Exempt Securities," in *Tax Exemptions* (New York: Tax Policy League, Inc., 1938), p. 52.

¹¹ *Hearings before the Ways and Means Committee* (1939), p. 449.

⁸ The chief source, the federal income-tax returns, cannot be depended upon to report this information accurately. There is evidence that interest received from tax-exempt obligations is more completely reported than the amounts of obligations owned. If interest received from tax-exempt securities reported for 1935 is related to reported amounts of securities owned, it reveals an average rate of interest on federal securities of 4.6 per cent and on state and local securities of 7.4 per cent. Both are in excess of those probably obtaining. Examination of specific cases indicates that this discrepancy may be due to failure of partnerships and fiduciaries to report to partners and beneficiaries amounts of government obligations held on their behalf in instances in which interest received is reported.

The argument that the withdrawal of tax exemption would raise the interest costs for certain local units to the point where they could not finance themselves is asking for a subsidy for an undertaking which is admittedly questionable for investors. If that increment of cost spells the difference between default and payment, then the unit was already on the border line. No more should a governmental unit be assisted in inducing an unsuspecting public to take its insecure issues than a private corporation be allowed that privilege. The end result on society is in many respects the same. To pour money from all taxpayers into a local questionable enterprise without investigation and the attempt to remedy the basic causes of the difficulty only tends to encourage the unstable venture and to impose upon investors a risk they should not be called upon to bear. That such a community needs assistance is a fact, but the kind of assistance which is needed is of a far more rudimentary and fundamental nature than is represented by enticing through exemptions for the interest on its issues. It was also demonstrated by the analyses involving low-grade bonds that tax exemption in the time of greatest need—in periods of great financial stress—is meaningless.

One of the major objections to local subsidies of this nature is the fact that support is furnished by persons who have no voice in the expenditures; and the careful-planning, efficient local administrators are penalized at the expense of those units which are more speculative in their spending of public funds.

This question of control, in such instances, of course, is a highly contested one, since it raises the issue of local autonomy and the so-called "intergovernmental immunity." In spite of the

various studies covering the legal issues involved in this question and the conclusions drawn in some instances that Congress has the power to tax state and local security income, the courts have not yet been given the issue squarely, since Congress has not asked for the test. If the trend of decisions on tangential issues can be taken as any indicator of the tenor of the courts, however, lines of demarcation eventually will be drawn between those state and local functions which are immune and those on which taxes may be imposed. For instance, the income from obligations secured by revenues as those derived from a publicly owned utility might be declared taxable, while those backed by property taxation, licenses, etc., might be declared exempt.¹² This line of demarcation, however, would not be a simple one to draw owing to the overlapping nature of some of these governmental functions.

It would seem that the argument that the existence of tax-exempt securities diverts capital from risk enterprise is extreme. The existence of such a riskless refuge for timid capital certainly does not help to force it into the channels of productive industry. However, it must be admitted that the existence of such a refuge is a condition and not a cause of capital's hiding. Eliminating the tax-

¹² The Supreme Court, in an order recently issued in preparation for its review of the *Saratoga Springs* case, asked the counsel to address themselves to two questions: (1) "May Congress constitutionally include for taxation in a generally applicable taxing act any state property or activity or the income derived by the state from them or any other source, so long as the tax does not discriminate against the state, or so long as the tax is not laid on the interest taxed, merely because it is that of a state—and if income of a private person from a like source may be constitutionally taxed?" (2) "To what extent may a state, by enlarging its property ownership or its activities, withdraw from the reach of the federal taxing power property and income which are normally subject to federal taxation when owned or received by private persons?"

exempt part of the governmental security haven would still not eliminate the riskless and liquidity features; and even if these should be prevented—which is difficult to envision without national collapse—capital which is not ready to take the chance would find other hiding places. Eliminating exemptions might remove some of the effects, but it would not touch the underlying causes. The argument that capital hides in tax exemptions also assumes that capital spent by public agencies is not as productive as that used by private corporations. While it is true that, under our free-enterprise system, corporate needs must be fed necessary capital, the above assumption with regard to governmental activity is open to question.

In spite of all the arguments which have been advanced in support of existing interest income exemptions, and court decisions to the contrary, it is felt that the same or better ends could be achieved by means which were far more equitable and desirable from the viewpoint of all the taxpayers. In so far as progressiveness, equality, or justice in

taxation is nullified by allowing the exemptions to stand, the means defeats the most desirable ends. On the other hand, any autonomy which local units might feel they were sacrificing might be guaranteed in other manners in order to insure protection and justice for the many against the few.

Corporations which attach to their bonds tax-free clauses do not in most cases recoup full financial returns for their outlays. The other elements present in these private issues have so much greater appeal to the investor as to dominate almost completely the tax-exemption incentive. However, from the viewpoint of a spreading of the market base and the inclusion of a different category of investors, such clauses in bonds may have merit for the issuers. Pennsylvania and Maryland are the only two states in which exemptions of the corporate free clause type have had any degree of importance. Because of the nature of the taxes imposed by those states, the falling pure interest rate has had the effect of enhancing the values of the bonds and thus increasing the levies imposed.

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APPENDIX

APPENDIX

TABLE 12

LIST OF BONDS USED IN STUDY

High Grade Corporate Bonds

United New Jersey Railroad and Canal, 4's of 1944
 St. Paul Union Depot, 4's of 1944
 St. Paul Union Depot, 5's of 1944
 Washington Terminal, 3½'s of 1945
 Washington Terminal 4's of 1945
 Kansas City Terminal Railway, 4's of 1960 (called 1945)
 Union Pacific Railroad, 4's of 1947
 Pittsburgh, Bessemer and Lake Erie Railroad, 5's of 1947
 Cleveland and Pittsburgh Railroad, 3½'s of 1948
 United New Jersey Railroad and Canal, 4's of 1948
 Southern New England Telephone Compnay, 5's of 1948
 New York Gas & Electric Light, Heat and Power Company, 5's of 1948
 New York Gas & Electric Light, Heat and Power Company, 4's of 1949
 United Electric Company of New Jersey, 4's of 1949
 Patterson and Passaic Gas and Electric Company, 5's of 1949
 Gas and Electric Company of Bergen County, 5's of 1949
 Cleveland and Pittsburgh Railroad, 3½'s of 1950
 Utica Electric Light and Power Company, 5's of 1950
 United New Jersey Railroad and Canal, 3½'s of 1951
 American Tobacco Company, 4's of 1951
 Tennessee Coal, Iron and Railroad Company, 5's of 1951
 Liggett and Meyers Tobacco Company, 5's of 1951
 Bridgeport Gas Light Company, 4's of 1952
 Consolidated Gas Company of Baltimore City, 4½'s of 1954
 Columbus and Toledo Railroad, 4's of 1955
 Indiana Harbor Belt Railroad, 4's of 1957
 Indiana Harbor Belt Railroad, 4½'s of 1957
 Pittsburgh, Cincinnati, Chicago and St. Louis Railway, 4's of 1960
 Winston Salem Southbound Railway, 4's of 1960
 Little Miami Railroad, 4's of 1962
 Pittsburgh, Cincinnati, Chicago and St. Louis Railway, 4½'s of 1963
 South and North Alabama Railroad, 5's of 1963
 Pittsburgh, Cincinnati, Chicago and St. Louis Railway, 4½'s of 1964
 United New Jersey Railroad and Canal, 4½'s of 1973
 Chesapeake and Ohio Railroad (Richmond and Allegheny Div.) 1st 4's of 1989
 Chesapeake and Ohio Railroad (Richmond and Allegheny Div.) 2nd 4's of 1989
 Scioto Valley and New England Railroad, 4's of 1989
 Chesapeake and Ohio Railroad, 4½'s of 1992
 Edison Electric Illuminating Company (New York), 5's of 1995
 Norfolk and Western Railway, 4's of 1996
 Hocking Valley Railway, 4½'s of 1999

High Grade Municipal Bonds

Massachusetts State, 4's of 1944
Springfield Massachusetts, 4's of 1944
New York State, 5's of 1945
Massachusetts State, 3½'s of 1945
New York State, 4's of 1946
Massachusetts State, 4's of 1945
Massachusetts State, 4's of 1948
Watertown, New York, 5's of 1945
Massachusetts State, 3½'s of 1948
Pennsylvania State, 4's of 1948
Baltimore, Maryland, 5's of 1946
New York State, 4's of 1949
Baltimore, Maryland, 4's of 1951
Watertown, New York, 5's of 1948
Massachusetts State, 3½'s of 1950
Baltimore, Maryland, 3½'s of 1952
Massachusetts State, 4's of 1951
Pennsylvania State, 5's of 1951
Massachusetts State, 4's of 1952
Watertown, New York, 4½'s of 1953
Baltimore, Maryland, 4's of 1955
New York State, 4's of 1958
Baltimore, Maryland, 4½'s of 1955
New York State, Highway 4's of 1960
New York State, Canal 4's of 1960
New York State, 4's of 1962
New York State, 4½'s of 1963
Baltimore, Maryland, 5's of 1961
New York State, 4½'s of 1964
Massachusetts State, 4½'s of 1970
New York State, 4's of 1962
New York State, Canal 4's of 1967
New York State, Highway 4's of 1967
New York State, Park 4's of 1967
Binghamton, New York, 4½'s of 1971
New York State, 5's of 1971

Low Grade Corporate Bonds

Cuba Railroad plus Grand Trunk of Canada, 6's of 1936
Atlanta and St. Andrews Bay, 6's of 1938
Union Railway (Third Avenue), 5's of 1942
Bangor and Aristook Railroad, 5's of 1943
Central of Georgia (Mac. and Nor. Div.), 5's of 1946
Missouri Pacific Railway Company, 5½'s of 1949
Havana Electric Railway Company, 5½'s of 1951
Jacksonville, Gainesville and Gulf Railway, 6's of 1951
Georgia, Florida and Alabama Railroad, 6's of 1952
Chesterfield and Lancaster Railroad, 5's of 1955
Associated Telephone and Telegraph Company, 5½'s of 1955
North American Light and Power Company, 5½'s of 1956
Missouri Pacific Railway Company, 5¼'s of 1956
Chicago, Rock Island and Pacific Railway Company, 4½'s of 1960
Chicago, Indianapolis and Louisville Railroad, 5's of 1966

Low Grade Municipal Bonds

Buncombe, North Carolina, 6's of 1937
Coral Gables, Florida, 6's of 1938
Clearwater, Florida, 5's of 1942
Asheville, North Carolina, 5's of 1943
Buncombe, North Carolina, 5's of 1946
Tarpon Springs, Florida, 5½'s of 1949
Tarpon Springs, Florida, 6's of 1951
Clearwater, Florida, 5½'s of 1953
Tarpon Springs, Florida, 5¼'s of 1955
Clearwater, Florida, 5½'s of 1955
Tarpon Springs, Florida, 5's of 1955
Clearwater, Florida, 6's of 1956
Coral Gables, Florida, 5½'s of 1956
Coral Gables, Florida, 6's of 1956
Tarpon Springs, Florida, 6's of 1956
Asheville, North Carolina, 5¼'s of 1957
Asheville, North Carolina, 4½'s of 1962
Asheville, North Carolina, 5's of 1969

Matched Corporate Bonds

Illinois Central Railroad, 1st gold 3½'s of 1951
Illinois Central Railroad, 1st ext. gold 3½'s of 1951

Denver Gas & Electric Light Company, 1st and ref. gold 5's of 1951
Denver Gas & Electric Light Company, 1st and ref. gold 5's (stamped) of 1951

Twin City Rapid Transit, 1st and ref. 5½'s, Series A, of 1952
Twin City Rapid Transit, 1st and ref. 5½'s, Series B, of 1952

Chicago and Northwestern Railway Co., Gen. Mort. 4's (stamped) of 1987
Chicago and Northwestern Railway Co., Gen. Mort. 4's of 1987

Chicago, Milwaukee and St. Paul Railway, Gen. 4½'s C of 1989
Chicago, Milwaukee and St. Paul Railway, Gen. 4½'s E of 1989

TABLE 13

BONDS IN SAMPLE OF PARTIALLY EXEMPT SECURITIES
INCLUDED IN STUDY

Kind	Issue			Date Bond First Includ- ed in Aver.	Date Bond First Exclud- ed from Aver.
	Coupon Rate	Call Date	Matu- rity Date		
1st Lib.Loan Conv.	4 1/4%	1932	1937	Jan. 1, 1919	June 16, 1924
2nd Lib.loan Conv.	4 1/4%	1927	1942	Jan. 1, 1919	Nov. 15, 1919
3rd Lib.loan	4 1/4%		1928	Jan. 1, 1919	Sept. 15, 1920
4th Lib.loan	4 1/4%	1933	1938	Jan. 1, 1919	Oct. 15, 1925
Treasury bond	4 1/4%	1947	1952	Nov. 1, 1922	Oct. 15, 1935
" "	4%	1944	1954	Dec. 15, 1924	Dec. 15, 1932
" "	3 3/4%	1946	1956	Mar. 15, 1926	Mar. 15, 1934
" "	3 3/8%	1943	1947	Jul. 12, 1927	June 15, 1931
" "	3 1/8%	1946	1949	June 15, 1931	June 15, 1934
" "	3%	1951	1955	Sept. 15, 1931	Sept. 15, 1939
" "	3 1/8%	1949	1952	Dec. 15, 1934	Dec. 15, 1937
" "	2 7/8%	1955	1960	Mar. 15, 1935	
" "	2 3/4%	1951	1954	June 15, 1936	June 15, 1939
" "	2 3/4%	1956	1959	Sept. 15, 1936	
" "	2 1/2%	1949	1953	Dec. 15, 1936	Dec. 15, 1937
" "	2 3/4%	1958	1963	June 15, 1938	
" "	2 3/4%	1960	1965	Dec. 15, 1938	
" "	2 1/4%	1954	1956	July 22, 1940	June 15, 1942
" "	2	1953	1955	Oct. 7, 1940	June 15, 1941

TABLE 14

RESOLUTIONS FOR CONSTITUTIONAL AMENDMENTS TO TAX INCOME
FROM GOVERNMENT SECURITIES, 1920-1943

Date Introduced	Introduced By	Congress	Resolution Number	Committee of Reference
1920-Dec. 28	Rep. McFadden	66th ¹	H.J.Res.429	Ways & Means
1921-May 3	Rep. McFadden	67th	H.J.Res.102	Ways & Means
Aug. 8	Sen. Smoot	"	S.J.Res.97	Judiciary
Oct. 25	Rep. McFadden	"	H.J.Res.211	Ways & Means
Dec. 10	Rep. Foster	"	H.J.Res.231	Ways & Means
Dec. 14	Rep. Green	"	H.J.Res.232	Ways & Means
1922-Apr. 28	Rep. Green	"	H.J.Res.314	Ways & Means ²
Dec. 8	Sen. Kellogg	"	S.J.Res.254	Judiciary
1923-Dec. 5	Rep. Green	68th	H.J.Res.1	Ways & Means
Dec. 10	Rep. Foster	"	H.J.Res.67	Ways & Means
Dec. 17	Rep. Dickinson	"	H.J.Res.101	Ways & Means
1924-Jan. 10	Rep. Green	"	H.J.Res.136	Ways & Means ²
Jan. 21	Rep. Little	"	H.J.Res.147	Ways & Means
Jan. 28	Rep. Little	"	H.J.Res.161	Ways & Means
Feb. 7	Rep. Huddleston	"	H.J.Res.174	Ways & Means
Feb. 10	Rep. Oliver	"	H.J.Res.193	Ways & Means
1925-Jan. 3	Rep. Green	"	H.J.Res.315	Ways & Means
Dec. 8	Rep. Garber	69th	H.J.Res.48	Ways & Means
Dec. 18	Rep. Oliver	"	H.J.Res.88	Ways & Means
1927-Dec. 5	Rep. Garber	70th	H.J.Res.24	Ways & Means
Dec. 5	Rep. Oliver	"	H.J.Res.43	Ways & Means
1928-Feb. 3	Rep. Hogg	"	H.J.Res.191	Ways & Means
1929-Apr. 17	Rep. Hogg	71st	H.J.Res.36	Ways & Means
1931-Dec. 9	Rep. Hogg	72nd	H.J.Res.112	Ways & Means
1932-Jan. 13	Rep. Burtness	"	H.J.Res.205	Ways & Means
Feb. 8	Sen. Bingham	"	S.J.Res.98	Judiciary
Apr. 4	Rep. Garber	"	H.J.Res.351	Ways & Means
Dec. 8	Sen. Ashurst	"	S.J.Res.224	Judiciary
Dec. 13	Rep. Campbell	"	H.J.Res.506	Ways & Means
1933-Jan. 10	Rep. Kunz	"	H.J.Res.550	Ways & Means
Jan. 10	Sen. Hull	"	S.J.Res.251	Judiciary
Feb. 1	Rep. Swanson	"	H.J.Res.584	Ways & Means
Feb. 9	Rep. Patman	"	H.J.Res.594	Judiciary
Mar. 9	Rep. Snyder	73rd	H.J.Res.55	Judiciary
Mar. 9	Sen. Ashurst	"	S.J.Res.7	Judiciary
Mar. 10	Rep. Patman	"	H.J.Res.68	Judiciary
Mar. 13	Sen. Capper	"	S.J.Res.25	Judiciary
Mar. 13	Sen. Costigan	"	S.J.Res.17	Judiciary
Apr. 4	Rep. Sanders	"	H.J.Res.146	Judiciary

¹Includes only the second and third sessions.²Went beyond the committee of reference

TABLE 14-Continued

Date Introduced	Introduced By	Congress	Resolution Number	Committee of Reference
1933-Apr. 13	Rep. Treadway	73rd	H.J.Res.153	Ways & Means
May 5	Rep. O'Malley	"	H.J.Res.175	Ways & Means
May 17	Rep. McFarlane	"	H.J.Res.184	Judiciary
June 6	Sen. Loneragan	"	S.J.Res.61	Judiciary
June 6	Rep. Disney	"	H.J.Res.197	Ways & Means
1934-Jan. 3	Rep. Mapes	"	H.J.Res.211	Judiciary
Jan. 4	Sen. Ashurst	"	S.J.Res. 7	Judiciary
Jan. 4	Sen. Costigan	"	S.J.Res. 68	Judiciary
Jan. 5	Rep. Deen	"	H.J.Res.219	Judiciary
Jan. 8	Rep. Sanders	"	H.J.Res.221	Judiciary
Jan. 9	Rep. Christianson	"	H.J.Res.222	Judiciary
Jan. 11	Rep. Chase	"	H.J.Res.225	Judiciary
Jan. 23	Rep. Celler	"	H.J.Res.239	Judiciary
Jan. 23	Rep. Celler	"	H.J.Res.240	Judiciary
Feb. 9	Rep. Fish	"	H.J.Res.268	Judiciary
Feb. 9	Rep. Stokes	"	H.J.Res.269	Judiciary
Feb. 14	Rep. Dowell	"	H.J.Res.274	Judiciary
Feb. 26	Rep. Disney	"	H.J.Res.284	Judiciary
Mar. 8	Rep. Oliver	"	H.J.Res.292	Judiciary
Mar. 22	Rep. Oliver	"	H.J.Res.305	Judiciary
1935-Jan. 3	Rep. Mapes	74th	H.J.Res.49	Judiciary
Jan. 3	Rep. Celler	"	H.J.Res.52	Judiciary
Jan. 3	Rep. Celler	"	H.J.Res.53	Judiciary
Jan. 3	Rep. O'Malley	"	H.J.Res.56	Judiciary
Jan. 3	Rep. Christianson	"	H.J.Res.57	Judiciary
Jan. 4	Sen. Costigan	"	S.J.Res.2	Judiciary
Jan. 4	Sen. Capper	"	S.J.Res.5	Judiciary
Jan. 7	Sen. Ashurst	"	S.J.Res.18	Judiciary
Jan. 9	Rep. Treadway	"	H.J.Res.66	Judiciary
Jan. 16	Rep. McFarlane	"	H.J.Res.98	Judiciary
Jan. 16	Rep. Fish	"	H.J.Res.101	Judiciary
Jan. 21	Rep. Disney	"	H.J.Res.124	Judiciary
Jan. 21	Rep. Bierman	"	H.J.Res.126	Judiciary
Jan. 23	Rep. Snyder	"	H.J.Res.128	Judiciary
Mar. 5	Rep. Houston	"	H.J.Res.194	Judiciary
June 20	Sen. Byrd	"	S.J.Res.150	Judiciary
June 24	Rep. Mahon	"	H.J.Res.334	Judiciary
June 29	Rep. Lundeen	"	H.J.Res.341	Judiciary
Aug. 2	Rep. Maas	"	H.J.Res.371	Judiciary
1936-Mar. 19	Rep. Snyder	"	H.J.Res.530	Judiciary
May 26	Rep. Ellenbogen	"	H.J.Res.598	Judiciary
1937-Jan. 5	Rep. Celler	75th	H.J.Res.2	Judiciary
Jan. 5	Rep. Dowell	"	H.J.Res.29	Judiciary
Jan. 5	Rep. Treadway	"	H.J.Res.34	Judiciary
Jan. 5	Rep. Carter	"	H.J.Res.42	Judiciary
Jan. 5	Rep. Celler	"	H.J.Res.44	Judiciary
Jan. 5	Rep. O'Malley	"	H.J.Res.77	Judiciary
Jan. 6	Sen. Loneragan	"	S.J.Res.5	Judiciary
Jan. 8	Sen. Capper	"	S.J.Res.25	Judiciary
Jan. 13	Rep. Carlson	"	H.J.Res.119	Judiciary

TABLE 14-Continued

Date Introduced	Introduced By	Congress	Resolution Number	Committee of Reference
1937-Jan. 14	Rep. Bierman	75th	H.J.Res.123	Judiciary
Jan. 19	Rep. Jones	"	H.J.Res.135	Judiciary
Feb. 4	Rep. Coffee	"	H.J.Res.192	Judiciary
Feb. 8	Rep. Mapes	"	H.J.Res.201	Judiciary
Feb. 15	Rep. Lord	"	H.J.Res.220	Judiciary
Feb. 16	Rep. Ellenbogen	"	H.J.Res.225	Judiciary
Mar. 2	Rep. Amilie	"	H.J.Res.256	Judiciary
Mar. 19	Rep. Knutson	"	H.J.Res.287	Judiciary
Apr. 2	Sen. Capper	"	S.J.Res.122	Judiciary
June 1	Sen. Byrd	"	S.J.Res.154	Judiciary
June 22	Rep. Snyder	"	H.J.Res.419	Judiciary
July 12	Rep. Ellenbogen	"	H.J.Res.441	Judiciary
Nov. 19	Rep. Sheppard	"	H.J.Res.512	Judiciary
Nov. 29	Rep. Smith	"	H.J.Res.521	Judiciary
Dec. 18	Rep. Snyder	"	H.J.Res.545	Judiciary
1938-Jan. 20	Rep. Healy	"	H.J.Res.570	Judiciary
Feb. 14	Sen. Hitchcock	"	S.J.Res.261	Judiciary
Feb. 25	Rep. Wearin	"	H.J.Res.603	Judiciary
Apr. 11	Rep. Culkin	"	H.J.Res.648	Judiciary
1939-Jan. 3	Rep. Dowell	76th	H.J.Res. 6	Judiciary
Jan. 3	Rep. Culkin	"	H.J.Res.39	Judiciary
Jan. 3	Rep. Smith	"	H.J.Res.49	Judiciary
Jan. 4	Sen. Capper	"	S.J.Res.26	Judiciary
Jan. 4	Rep. Mapes	"	H.J.Res.60	Judiciary
Jan. 4	Rep. Snyder	"	H.J.Res.61	Judiciary
Jan. 12	Rep. Knutson	"	H.J.Res.106	Judiciary
Jan. 31	Rep. Sheppard	"	H.J.Res.143	Judiciary
Feb. 7	Rep. Kean	"	H.J.Res.155	Judiciary
1941-Jan. 3	Rep. Kean	77th	H.J.Res.19	Judiciary
Jan. 3	Rep. Snyder	"	H.J.Res.27	Judiciary
Jan. 6	Sen. Capper	"	S.J.Res.6	Judiciary
Jan. 29	Rep. Knutson	"	H.J.Res. 94	Judiciary
1943-Jan. 8	Rep. Knutson	78th	H.J.Res.43	Judiciary

Sources: U. S. Library of Congress, Legislative Reference Service, Proposed Amendments of the Constitution for the Taxing of Federal and State Securities (9 typewritten pages), 1920-1933; Congressional Record, Indexes, 1934-1936; Library of Congress, Legislative Reference Service, Digest of Public General Bills, 1937-1943.

TABLE 15

INCOME TAX RATES: NINETEENTH CENTURY, INDIVIDUAL NORMAL,
AND CORPORATE NORMAL, 1861-1941

19th Century				Individual Normal			Corporate Normal	
Rate (%)	Income Bracket		Act of	Rate (%)	Net Income Bracket	Year Appli- cable	Rate (%)	Year Appli- cable
	From	Includ- ing						
3			1861	1		1913-15	1	1909-12
3	\$600	\$10,000	1862	2		1916	1	1913-15
5	10,000			2	1st \$2,000	1917	2	1916
5	600	5,000	1864	4	from 2,000		6	1917
7½	5,000	10,000		6	1st 4,000	1918	12	1918
10	10,000		1864	12	from 4,000		10	1919-21
5	600		1864	4	1st 4,000	1919-20	12½	1922-24
5	600	5,000	1865	8	from 4,000		13	1925
10	5,000			4	1st 4,000	1921-23	13½	1926-27
5	1,000		1867	8	from 4,000		12	1928
2½	2,000		1870	2	1st 4,000	1924	11	1929
2	4,000		1894	4	2nd 4,000		13¾	1932-34
				6	from 8,000	12½-15	1935	
				1½	1st 4,000	1929	8-15	1936-37
				3	2nd 4,000		12½-19 ^a	1938
				5	from 8,000	1932-33	12½-18 ^a	1939
				4	1st 4,000		13½-19 ^a	1940
				8	from 4,000	1934-41	15-24 ^a	1941-42
				4		1942-43		
				6				

^aRate applicable based on size and type of corporation. Beginning in 1938, different rates effective when corporation elects to use alternative method for tax computation.

Source: Official U. S. Government records.

TABLE 16

INCOME TAX RATES: INDIVIDUAL SURTAX, 1913-41

(Net income expressed in thousands of dollars; rates in per cents)

Net Income		Rates and Years to Which Applicable													
Over	Not over	1913-1915	1916	1917	1918-1922-1923 ^a	1924	1925-1931	1932-1933	1934-1935	1936-1939	1940	1941	1942-1943	1944	
	2												6	13	20
2	4												9	16	22
4	5												13	20	26
5	6				1	1							13	20	26
6	7½				1	2	1						17	24	30
7½	8				2	2	1			1	5	5	6	17	24
8	10				2	3	1			1	6	6	8	21	28
10	12				3	4	2	1	1	2	7	7	10	25	32
12	12½				3	5	3	1	1	3	8	8	12	29	36
12½	13				4	5	3	1	1	3	8	8	12	29	36
13	14				4	5	3	1	1	3	8	8	12	29	36
14	15				4	6	4	2	2	4	9	9	15	32	40
15	16				5	6	4	2	2	4	9	9	15	32	40
16	18				5	7	5	3	3	5	11	11	18	35	43
18	20				5	8	6	4	4	6	13	13	21	38	46
20	22	1	1		8	9	8	5	5	8	15	15	24	41	49
22	24	1	1		8	10	9	6	6	9	17	17	27	44	52
24	26	1	1		8	11	10	7	7	10	17	17	27	44	52
26	28	1	1		8	12	11	8	7	11	19	19	30	47	55
28	30	1	1		8	13	12	9	8	12	19	19	30	47	55
30	32	1	1		8	14	13	10	8	13	19	19	30	47	55
32	34	1	1		8	15	15	10	9	15	21	21	33	50	58
34	36	1	1		8	16	15	11	9	15	21	21	33	50	58
36	38	1	1		8	17	16	12	10	16	21	21	33	50	58
38	40	1	1		8	18	17	13	10	17	24	24	36	53	61
40	42	1	2		12	19	18	13	11	18	24	24	36	53	61
42	44	1	2		12	20	19	14	11	19	24	24	36	53	61
44	46	1	2		12	21	20	15	12	20	27	27	40	55	63
46	48	1	2		12	22	21	16	12	21	27	27	40	55	63
48	50	1	2		12	23	22	17	13	22	27	27	40	55	63
50	52	2	2		12	24	23	18	13	23	30	31	44	57	66
52	54	2	2		12	25	24	19	14	24	30	31	44	57	66
54	56	2	2		12	26	25	19	14	25	30	31	44	57	66
56	58	2	2		12	27	26	20	15	26	33	35	44	57	66
58	60	2	2		12	28	27	21	15	27	33	35	44	57	66
60	62	2	3		17	29	28	21	16	28	33	35	47	59	69
62	64	2	3		17	30	29	22	16	29	36	39	47	59	69
64	66	2	3		17	31	30	23	17	30	36	39	47	59	69
66	68	2	3		17	32	31	24	17	31	36	39	47	59	69
68	70	2	3		17	33	32	25	17	32	39	43	47	59	69
70	72	2	3		17	34	33	26	18	33	39	43	50	61	72
72	74	2	3		17	35	34	26	18	34	39	43	50	61	72
74	75	2	3		17	36	35	27	18	35	42	47	50	61	72
75	76	3	3		17	36	35	27	18	35	42	47	50	61	72
76	78	3	3		17	37	36	28	18	36	42	47	50	61	72
78	80	3	3		17	38	37	28	18	37	42	47	50	61	72
80	82	3	4		22	39	38	29	19	38	45	51	53	63	75
82	84	3	4		22	40	39	30	19	39	45	51	53	63	75
84	86	3	4		22	41	40	31	19	40	45	51	53	63	75
86	88	3	4		22	42	41	31	19	41	45	51	53	63	75
88	90	3	4		22	43	42	32	19	42	45	51	53	63	75
90	92	3	4		22	44	43	33	19	43	50	55	56	64	77
92	94	3	4		22	45	44	34	19	44	50	55	56	64	77
94	96	3	4		22	46	45	35	19	45	50	55	56	64	77
96	98	3	4		22	47	46	36	19	46	50	55	56	64	77
98	100	3	4		22	48	47	36	19	47	50	55	56	64	77
100	150	4	5		27	52	48	37	20	48	52	58	58	65	79
150	200	4	6		31	56	49	37	20	49	53	60	60	66	81
200	250	4	7		37	60	50	38	20	50	54	62	62	67	82
250	300	5	8		42	60	50	38	20	50	54	64	64	69	82
300	400	5	9		46	63	50	39	20	51	55	66	66	71	82
400	500	5	9		46	63	50	39	20	52	56	68	68	72	82
500	750	6	10		50	64	50	40	20	53	57	70	70	73	82
750	1,000	6	10		55	64	50	40	20	54	58	72	72	74	82
1,000	1,500	6	11		61	65	50	40	20	55	59	73	73	75	82
1,500	2,000	6	12		62	65	50	40	20	55	59	73	73	75	82
2,000	5,000	6	13		63	65	50	40	20	55	59	74	74	76	82
5,000		6	13		63	65	50	40	20	55	59	75	75	77	82

^aTax for 1923 reduced 25%, by credit or refund, by Revenue Act of 1924.

Source: Official U. S. Government records.

TABLE 17

ESTIMATED AMOUNT OF TAX-EXEMPT SECURITIES OUTSTANDING, BY
GOVERNMENTAL UNITS IN THE UNITED STATES, CLASSIFIED
BY TAX STATUS AND TYPE OF ISSUER, 1913-42

(In billions of dollars)

June 30-	Wholly Exempt				Partially Exempt			Total Fed. Govt. ¹	% Total Interest Bearing Fed. Debt Exempt.
	Total ¹	Fed.	Fed. Agen- cies ²	States, Locali- ties	Total	Fed.	Fed. Agen- cies		
1913	5.53	.97		4.53				.97	100.0
1914	5.95	.97		4.95				.97	100.0
1915	6.43	.97		5.42				.97	100.0
1916	6.89	.97		5.88				.97	100.0
1917	9.05	2.71		6.29				2.71	100.0
1918	9.19	2.39	.11	6.64	9.60	9.60		11.99	100.0
1919	10.16	2.80	.27	7.04	22.59	22.59		25.23	100.0
1920	11.31	3.11	.40	7.75	20.95	20.95		24.06	100.0
1921	11.92	2.94	.45	8.48	20.80	20.80		23.74	100.0
1922	12.99	2.29	.73	9.89	20.42	20.42		22.71	100.0
1923	14.07	2.29	1.06	10.60	19.71	19.71		22.01	100.0
1924	15.29	2.29	1.23	11.63	18.69	18.69		20.98	100.0
1925	16.65	2.18	1.51	12.83	17.94	17.94		20.11	99.5
1926	17.64	2.16	1.66	13.66	17.02	17.02		19.18	98.8
1927	18.85	2.16	1.79	14.74	15.73	15.73		17.89	98.0
1928	19.89	2.17	1.87	15.70	14.69	14.69		16.86	97.3
1929	20.96	2.17	1.87	16.76	13.86	13.86		16.03	96.3
1930	23.61	3.59	1.87	17.99	11.57	11.57		15.16	95.2
1931	25.52	4.41	1.89	19.06	11.81	11.81		16.23	98.2
1932	28.06	6.79	1.78	19.33	12.42	12.07	.35	18.85	98.4
1933	31.18	9.81	1.69	19.52	13.61	12.03	1.59	21.84	98.6
1934	32.96	11.80	2.19	18.82	15.78	14.24	4.55	26.03	98.3
1935	34.45	12.93	2.40	18.97	21.77	13.99	7.78	26.93	97.4
1936	36.32	14.65	2.32	19.21	26.23	17.48	8.75	32.13	98.1
1937	35.03	13.51	2.23	19.15	29.06	20.74	8.32	34.24	95.6
1938	32.26	10.82	2.15	19.17	28.92	23.09	5.84	33.90	92.7
1939	30.90	9.03	2.09	19.63	32.99	27.09	5.90	36.12	90.5
1940	30.25	8.14	2.06	19.89	35.14	29.46	5.68	37.60	88.7
1941	26.83	4.90	1.92	19.86	36.03	30.16	5.87	35.07	72.5
1942	25.51	4.26	1.73	19.38	33.10	30.07	3.02	34.32	47.6

¹Is not a true sum of horizontal items shown on table due to rounding of numbers.

²Includes federal instrumentalities whose securities are guaranteed and those whose issues are not guaranteed.

Source: Adapted from federal Treasury data.

TABLE 18

ESTIMATED OWNERSHIP OF TAX-EXEMPT GOVERNMENT SECURITIES,
CLASSIFIED BY TAX STATUS, 1937-42

(Par value In billions of dollars)

Holder and Type of Holdings	1937	1938	1939	1940	1941	1942
Government funds, etc.: ¹						
Wholly exempt	7.0	7.2	7.0	6.6	6.5	6.4
Partially exempt	6.5	3.9	3.5	3.9	3.8	3.5
Total	13.5	11.1	10.5	10.5	10.3	9.9
Privately held:						
Wholly exempt	28.0	25.1	23.9	23.6	20.3	19.1
Partially exempt	22.5	25.0	29.5	31.2	32.2	29.6
Total	50.5	50.1	53.4	54.8	52.5	48.7
Commercial banks: ²						
Wholly exempt	9.0	7.7	7.3	7.6	6.1	5.5
Partially exempt	8.7	9.6	12.1	13.1	13.9	13.2
Total	17.7	17.3	19.4	20.7	20.0	18.7
Mutual savings banks: ²						
Wholly exempt	1.1	.9	.9	.9	.6	.5
Partially exempt	2.1	2.5	2.9	2.9	2.4	1.6
Total	3.2	3.4	3.7	3.7	3.0	2.1
Insurance companies:						
Wholly exempt	3.1	2.8	2.6	2.5	2.3	2.2
Partially exempt	3.7	4.6	5.3	6.1	6.0	5.8
Total	6.8	7.4	7.9	8.6	8.3	8.0
Other corporations:						
Wholly exempt	1.8	1.5	1.3	1.2	.8	.8
Partially exempt	1.0	1.1	1.2	1.2	1.2	1.2
Total	2.8	2.6	2.5	2.4	2.0	2.0
Tax-exempt institutions: ³						
Wholly exempt	.6	.6	.8	.8	.6	.6
Partially exempt	.4	.4	.5	.5	.5	.4
Total	1.0	1.0	1.3	1.3	1.1	1.0
Individuals partnerships, personal trust accounts: ⁴						
Wholly exempt	12.4	11.3	11.0	10.6	9.9	9.5
Partially exempt	6.6	6.8	7.6	7.5	8.2	7.4
Total	19.0	18.4	18.6	18.1	18.1	16.9

¹Comprises securities held by (1) U.S. Government agencies and trust funds (including exchange stabilization fund), (2) Federal Reserve Banks, and (3) sinking, trust, and investment funds of State and local governments and of territories and insular possessions.

²Book values used instead of par values.

³Other than mutual savings banks.

⁴Residuals obtained by subtracting other holdings from totals outstanding.

Source: U. S. Treasury.

